



BUNDLING IN TELECOMMUNICATIONS MARKETS

**SUBMISSION BY AAPT LIMITED IN RESPONSE TO
THE ACCC DRAFT INFORMATION PAPER**

MARCH 2003



1. INTRODUCTION

AAPT Limited welcomes the opportunity to provide a submission in response to the Commission's draft information paper *Bundling in Telecommunications Markets*, January 2003.

AAPT is pleased that the Commission has recognised the telecommunications industry's growing concerns regarding the anti-competitive purpose and effects of bundling in respect of offerings of telecommunications services and the combination of such services with non-telecommunications services. AAPT hopes the Commission will take an active role in ensuring that currently anti-competitive bundled offerings are withdrawn from the market and that, in the future, such offerings are not permitted to be introduced.

AAPT would be pleased to meet with Commission staff to answer any questions they have in relation to this submission.

2. EXECUTIVE SUMMARY

AAPT considers that:

- bundling can be beneficial or detrimental. Principal concerns arise with bundling by a carrier or carriage service provider (**CSP**) which has a substantial degree of market power or is vertically integrated. Bundling can be anti-competitive if:
 - a carrier or CSP with substantial market power in the supply of at least one of the services in its bundled offering leverages that power into a market in which another service in the bundle operates and which is more contestable or competitive; or
 - a vertically integrated carrier or CSP reduces the addressable market of competing carriers or CSPs by engaging in price squeezes or preventing them from being able to acquire one of the services in the bundled offer so that competitors are effectively foreclosed from competing;

Therefore, where a carrier or CSP bundles a service in which it has the requisite market power or is vertically integrated, the bundling conduct should be closely examined by the Commission to assess whether it is anti-competitive;

- imputation analysis can be a useful tool for detecting whether certain bundling is likely to have anti-competitive effects. However, it can be highly subjective and manipulated, which may make an assessment of the likely effects of bundling difficult. Measures therefore need to be adopted to ensure the robustness of the

assumptions and inputs used when conducting imputation testing and care needs to be taken not to overstate the role of such testing in assessing whether bundling is anti-competitive;

- AAPT agrees with the Commission’s proposal for the public disclosure of information it uses when conducting imputation analysis. AAPT considers that the Commission should also consult with industry participants whenever it is carrying out imputation testing on bundled offers in order to test the assumptions made and the reliability of the results;
- while the n/e/r/a report released with the draft information paper entitled “Imputation tests for bundled services”, is competent, it is generally too favourable to a firm with market power and skates over some of the difficulties with imputation tests and bundled offers, particularly in relation to common costs. These concerns are developed in the paper by Professor Stephen King attached to this submission;
- the Commission should be encouraged to review bundling in the telecommunications industry under:
 - Part IV of the *Trade Practices Act* 1974 (**Act**) (namely sections 45(2), 46 and 47(2) and (3)); and
 - under the competition rule in Part XIB of the Act.

The Commission should also be encouraged to utilise its information gathering powers in section 155 of the Act and the record keeping and tariff filing rules in Part XIB of the Act when reviewing bundling practices;

- legislative reform to Parts XIB and XIC of the Act would enable the Commission to more effectively address the problems that bundling currently poses for the telecommunications industry. AAPT recommends that:
 - Part XIB be amended to provide that the offer of a bundle by Telstra will amount to a breach of the competition rule unless the Commission considers the conduct is not likely to have the effect of substantially lessening competition in a telecommunications market. Under this proposal, Telstra, before it offers a retail bundle or seeks to vary an existing bundled that it offers at the retail level, would be required to notify the Commission and obtain its approval; and
 - Part XIC be amended to require Telstra to offer to access seekers a wholesale service delivered by means of Telstra’s fixed network where Telstra is supplying that service in a bundled offer at the retail level. Telstra would only be required to do this if the Commission determines that the likely effect of Telstra’s bundled offering is to substantially lessen competition in a market. This proposed amendment is similar, although not identical, to a provision that operates under the New Zealand *Telecommunications Act* 2001.

AAPT's submission is organised as follows:

- **section 3** adds to the comments made by the Commission in the draft information paper on the potential public benefits and detriments of bundling;
- **section 4** examines current bundling in the telecommunications industry by examining Telstra's behaviour;
- **section 5** makes some suggestions in relation to the Commission's practical application of the provisions in the Act that can be used to address the anti-competitive purpose or effects of bundling in the telecommunications industry;
- **section 6** describes AAPT's recommendations, and rationale, for supplementing the existing legislative mechanisms available to the Commission to overcome any anti-competitive bundling; and
- **Annexure A** contains comments prepared by Professor Stephen King entitled "Comments on "Bundling in telecommunications markets: An ACCC draft information paper"".

This submission is focused on bundling directed towards residential and small business customers because the details of that bundling are generally available. However, AAPT is equally concerned about bundling to corporate customers in the telecommunications industry.

3. THE POTENTIAL BENEFITS AND DETRIMENTS OF BUNDLING

3.1 AAPT's response to the Commission's comments

Bundling can provide benefits. However, bundling by a service provider with market power may be anti-competitive.

AAPT agrees with the Commission's observations regarding the potential benefits and detriments of bundling¹ and in particular that:

- bundling may have associated benefits or detriments depending on the specifics of the conduct;
- relevant factors to consider are: the extent of market power held by the carrier or CSP providing the bundle; the types of services being offered in the bundle; the structure of the markets for these services; and any price discounts that are offered; and
- while there may be short term benefits associated with bundling, in some instances, there may be long term detriment which can result in a substantial lessening of competition.

Bundling, as with many aspects of competitive behaviour, can be a vehicle for innovation, product differentiation and enhanced competitive outcomes. Bundling can provide benefits both to the party bundling and to the customer. From the customers' perspective the bundle can be attractive if it allows the

¹ ACCC, *Bundling in Telecommunications Markets*, An ACCC draft Information paper, January 2003, at pages 6-7.

customer to receive one bill for the range of services included in the bundle. Customer preference for this structure is understandable as it may reflect lower transaction costs and administrative convenience.

Bundled offers can also be attractive to customers if they enable them to receive discounts off the prevailing prices for products in the bundle. However, where the carrier or CSP offering the bundle has a substantial degree of market power in relation to one of the products in the bundled offering, and uses that power to hold prices for products in the bundle artificially above those that would otherwise prevail in the market, bundling is likely to have detrimental impacts on competition.

Bundling will be anti-competitive in the longer term if customers are locked into a bundle, or customer inertia operates so that customers are reluctant to switch providers, and the carrier or CSP offering the bundle is able to increase the price of the bundle, or its particular elements, without regard to competitive forces. Depending on the service provider's degree of market power and the competitive dynamics of the relevant industry, a service provider will over time be able to charge higher prices for each of the offerings in the bundle than they would otherwise have been able to charge. Such higher prices are likely to remove the benefits to the customer of the initial discounts that applied to a bundled offering.

Bundling by a carrier or CSP with the requisite market power should be closely analysed, as the capacity to leverage power from one market to another increases the potential for detrimental impacts on competition. Of particular concern is where a carrier or CSP leverages its market power into a more contestable market, for example, Telstra's leverage of its dominance in the customer access network (CAN) by including in its bundles, services delivered by means of that network.

AAPT agrees with the Commission that two of the important considerations in assessing whether bundling is anti-competitive are:

- whether the bundling conduct significantly reduces the addressable market of competing carriers or CSPs; and
- whether the price for the bundle involves a vertical price squeeze.²

AAPT also agrees with the Commission that these consequences are likely to occur when the carrier engaging in the bundling conduct has a substantial degree of market power and leverages that power into other more contestable markets and/or is vertically integrated.³ Telstra's market power necessitates that its bundling conduct be closely examined.

3.2 Reduction in addressable market

Analysis of the reduction in an addressable market should be by reference to all customers that are foreclosed to the competitor.

² ACCC, *Bundling in Telecommunications Markets*, An ACCC draft Information paper, January 2003, at page 13.

³ Ibid.

AAPT generally agrees with the comments made by the Commission on the analysis of addressable markets and bundling, and wishes to make some qualifications to those comments.

In relation to a reduction in addressable market, the Commission comments:

- addressable market is defined as *'the proportion of consumers in a particular market that are in effect available to competitors'*; and
- the means by which a carrier can effect a reduction in another's addressable market is described as follows: *'bundling the service for which it has substantial market power, a carrier may be able to significantly reduce its competitors' addressable markets for the other services in the bundle'*.⁴

The Commission notes that there are three circumstances in which bundling by a carrier with substantial market power is likely to be anti-competitive by reason of its reducing a competitor's addressable market:

- where the pricing of the bundle strongly encourages a significant proportion of consumers to purchase the bundle of services rather than individual services from competing carriers and CSPs;
- where the carrier only supplies the services for which it has substantial market power within the bundled package; and
- where a significant proportion of consumers only acquire their services from one carrier by reason of their obtaining one-bill.⁵

AAPT considers that the following qualifications need to be made in respect of the above approaches by the Commission:

- any analysis of the reduction in addressable market brought about by bundling should not be limited to those markets which are more contestable. The reduction should be assessed by reference to all customers that are foreclosed to the competitor. In Telstra's case, for example, this includes local call and basic access customers. The assessment should not be limited merely to the foreclosure of customers for the *'other services in the bundle'*; and
- there are factors in addition to those listed by the Commission that can account for a reduction in an addressable market where the carrier or CSP has market power. These additional factors include switching costs, customer inertia, concerted retention strategies, and whether competitors can offer the services included in the bundled on comparable terms. AAPT considers that each of these factors should be considered by the Commission in forming a view as to whether a bundled package significantly reduces the addressable market available to competitors.

⁴ Ibid, at page 14.

⁵ Ibid.

3.3 Tying

Virtual tying strategies by carriers or CSPs with market power are likely to be anti-competitive.

AAPT considers that the n/e/r/a report entitled '*Anti-competitive bundling strategies*' indicates beyond doubt that tying is anti-competitive. AAPT has the following comments in relation to the approach in this report:

- n/e/r/a states that 'tying' occurs when a firm makes consumers' purchases of product A conditional on the purchase of product B (**technical tying**).⁶ While n/e/r/a also states that tying can be said to occur when the consumer is offered a discount on product A conditional on their purchase of product B (**virtual tying**), it does not proceed to consider that form of tying. In relation to technical tying, n/e/r/a's view is that if certain conditions are met, technical tying will more than likely be anti-competitive (although there may be a positive overall impact), but suggests that the anti-competitive effects of virtual tying should be dealt with on the basis of imputation analysis and predatory pricing. One of those conditions is that the firm has market power in relation to product A and further, that consumers cannot by-pass the firm for the purchase of that product;
- AAPT disagrees that tying is only problematic if consumers cannot by-pass the firm producing the 'tying' product. AAPT submits that it is sufficient if the firm has a substantial degree of power in the market for the tying product; and
- AAPT considers the distinction between technical tying and virtual tying to be over emphasised. In circumstances where a firm is dominant in relation to the supply of product A, there is no relevant difference between offering a discount of 10% on product A or not offering product A at all. n/e/r/a however suggests that the anti-competitive effects of the former conduct should be assessed on the basis of a stringent test, namely, whether the firm is engaging in predatory pricing or a vertical price squeeze.

3.4 Ability of Telstra to leverage its market power

Where Telstra or another carrier or CSP bundles a service for which it has the requisite market power, the conduct should be closely examined by the Commission to assess whether it is anticompetitive.

Telstra has substantial market power, particularly in fixed-line telephony markets, which is derived from:

- Telstra's control of the CAN and the lack of competitive infrastructure. Notwithstanding some level of competitive infrastructure provided by Optus' HFC network, any service provider wanting to provide any-to-any interconnectivity must have access to Telstra's CAN. Further, the extent of roll out of competitive

⁶ n/e/r/a, *Anticompetitive bundling strategies*, January 2003, at page 2

telecommunications infrastructure is low in comparison with global standards;

- the size of Telstra's customer base (95% of local access services);⁷
- Telstra's history as the incumbent supplier, from which it derives advantages including that:
 - as the key provider of basic access Telstra is necessarily the preferred supplier of all call services. End users must make a deliberate choice for a competitive service provider, which may involve operation shortcomings (for example, use of an override code);
 - Telstra remains the only full service telecommunications provider;
 - Telstra is able to include all services on one bill;
 - Telstra has access to customer information;
 - Telstra alone has national coverage;
 - being the incumbent and the universal service provider brings Telstra brand recognition; and
 - as incumbent Telstra has certain cost benefits of network operations (eg. early acquisition of sites (for exchanges, towers), established land access (for trenches), established arrangements with equipment suppliers);⁸
- barriers to switching;⁹ and
- the fact Telstra is vertically integrated such that sustainable service-based competition in local telephony is dependent on Telstra's local call wholesale service¹⁰.

Telstra's market power provides it with the potential to use bundling as a means of leveraging market power from one market to another. AAPT has previously raised with the Commission the potential for bundling by Telstra to raise serious competitive concerns.¹¹ In particular, Telstra may leverage its substantial power in the national local telephony service market into more contestable markets such the long distance, mobile and internet services markets as well as the developing subscription television services market.

While Telstra's market power does not necessarily imply that anti-competitive behaviour is occurring, it does indicate that the necessary

⁷ Productivity Commission, op cit.

⁸ Professor Jean-Jacques Laffont, February 2002.

⁹ For example, in the United Kingdom an investigation by the Director General of Telecommunications into certain pricing practices by British Telecom, found that there is some evidence that significant barriers to switching exist, which prevent customers changing suppliers to take advantage of competing offers.

¹⁰ Productivity Commission, op cit.

¹¹ See the presentation by AAPT Limited to Rod Shogren, 18 October 2001.

prerequisites are in place, and that there are strong incentives to act in this way.

3.5 The anti-competitive effects of reduced customer churn

Bundling reduces customer churn, reducing the size of the addressable market.

Apart from the impacts of leverage, there are significant incentives for a service provider to offer a bundled package such as:

- reducing customers incentives to mix and match and use separate service providers; and
- reducing the opportunities available to competitors to attract customers away from their existing service provider and increasing the cost of them doing so.

Bundling reduces the level of customer churn. This is well recognised by Telstra and Optus in the following statements:

We've found that customers are two to three times less likely to change carrier if they are taking a package and they are on one bill.¹²

Fixed line + mobile + internet = customer loyalty & reduced churn.¹³

The bundled product network entry strategy is also important in reducing customer churn. For example, CWO market data indicates that those customers who take a bundled set of CWO services are far less likely to churn their individual services, such as local and long distance telephony, to other service providers.¹⁴

We began by introducing single bill options for customers with fixed and mobile services early last year. More than 700,000 customers, or just over 10% now get a single bill. This alone has a significant impact on reducing churn for both fixed and mobile customers. ... Last September, we introduced "true" bundled product offerings to the residential market, where customers receive discounts when they group together their fixed, mobile and Internet services. The early results are very pleasing, with nearly half of million customers signing up in the first three months. These customers are twice as likely to be high value and three to four times as likely to remain loyal to Telstra. ... So, while bundling has failed for others, it is certainly working for Telstra.¹⁵

As bundling reduces the extent of customer churn, the inability to reduce churn and the costs of achieving a reduction in customer churn will be higher for those providers who are not able to offer each of the services in the bundled on a competitive basis. This increases barriers to entry in the

¹² Ted Pretty, quoted by Anne Davies, *"Bundling is Online Mantra For Telstra"*, *Sydney Morning Herald*, 5 December 2000.

¹³ Dr Switkowski, Credit Suisse First Boston Conference, March 2001.

¹⁴ Adrian Chamberlain, *The Importance of Pay TV Programming in Driving Investment in the Information Society*, paper presented at the Australian Broadcasting Authority Conference on Radio, Television and the New Media, Canberra, 3-4 May 2001, at paragraph 1.8.

¹⁵ Dr Switkowski, Credit Suisse First Boston Conference, op cit.

relevant markets and makes it more difficult for existing providers to attract customers away from Telstra.

The more successful the bundled offerings are, the more likely that over time the products supplied in a market will change in a way such that it is only the providers of the bundled offering that have the ability to attract customers.

Telstra has the potential to bundle services with its fixed-line telephony and:

- use the bundled offerings to attract and retain high value customers from existing service providers thereby further increasing its substantial market power and the competitive advantages it derives from being able to offer bundled services;
- reduce the level of churn it currently experiences. Telstra recognises that the level of churn between providers of long distance telephony services is indicative of the competitive nature of the market for the provision of long distance telephony services;¹⁶ and
- act in a discriminatory way and take advantage of cross subsidisation opportunities between monopoly areas of a business and areas in which new entrants are attempting to compete.

3.6 Vertical price squeezes and imputation tests

Imputation tests are useful in identifying a vertical price squeeze, but their significance can be overstated. Whether a price squeeze occurs is a factual question, not evidenced solely by the outcome of an imputation test.

Where there are common costs, there is no unambiguous imputation rule.

AAPT believes that imputation testing can be a useful tool in identifying a vertical price squeeze, but identifies the following limitations with such testing:

- imputation testing needs to be conducted prospectively for it is often a slow and complex task;
- it can be inconclusive;¹⁷
- there is a danger that the significance of imputation testing can be overstated. Such testing should not supplant the terms of the Act. AAPT considers that if a bundled offering fails an imputation test this is sufficient, but not necessary, evidence that the setting of the pricing is at a level that *'strongly encourages a significant proportion of consumers to purchase the bundle'*. A provider with substantial market power may price a bundle to strongly encourage a significant proportion of customers to purchase it and yet not engage in predatory pricing or a vertical price squeeze. This issue is a factual question that will be made out or otherwise on the basis of primary

¹⁶ Telstra's submission in support of exclusive dealing notifications lodged with the Commission on 15 July 2002, at paragraph 11.8.

¹⁷ See recent investigations in the United Kingdom, BSkyB Investigation – alleged infringement of the Chapter II prohibition, 17 December 2002 where the Office of Fair Trading found that the imputation analysis returned a borderline result.

evidence. Such evidence, in Telstra's case, may include factors such as:

- customers acquiring services under the Telstra Options Rewards program are twice as likely to be high value customers and three to four times as likely to remain loyal to Telstra;¹⁸
- in March 2001, Telstra indicated that nearly 500,000 customers signed up within the first 3 months to the Telstra Options Rewards program. In January 2003, Telstra indicated that almost 25% of its customers had signed up to the Telstra Options Rewards program¹⁹ and predicted significant increases in take up rates. This is a substantial number of customers when one considers that, to be eligible for the program, customers must acquire local calls and basic access from Telstra; and
- Telstra has publicly indicated its finding that local customers are less likely than other customers to churn to another provider;²⁰
- imputation testing needs to be conducted vigorously to minimise the prospect of it being manipulated by those providing the input data;
- data obtained by the Commission under one or other of its information-gathering powers should be made public whenever possible. In this regard AAPT agrees with the preference of the Commission,²¹ to disclose to the public, information on which it conducts any imputation test. This would enable other carriers and CSPs, being those with the greatest ability to assess the information provided, to contribute to the analyses; and
- there are unresolved issues as to the appropriate allocation of common costs. The imputation tests for bundled services described by n/e/r/a²² do not adequately account for common cost allocation and do not appear to prevent the dominant carrier inappropriately attributing common costs to individual components of the bundle. Please see the comments of King in the Annexure to this paper where this issue is dealt with in more detail, and in particular King's comment that where there are common costs there is no unambiguous imputation rule.²³

¹⁸ Ibid.

¹⁹ Credit Suisse First Boston analysis, 23 August 2002.

²⁰ Ted Pretty, quoted by Anne Davies, op cit.

²¹ ACCC, *Regulatory Principles for the Public Disclosure of Record-Keeping Rule Information*, January 2003.

²² n/e/r/a, *Imputation tests for bundled services*, January 2003 published with the Commission's draft bundling information paper.

²³ Annexure A, at page 2.

3.7 Ability of Telstra to effect price squeezes

Telstra's ownership of the CAN enables it to effect vertical price squeezes. Accordingly, bundling by Telstra raises competition issues not present in packaging by other service providers.

An upfront approach to checking Telstra's bundled pricing is required. The onus for showing that a bundled offering is not anti-competitive should be placed on Telstra.

Telstra should be required to account for the discounts associated with its bundle by reference to costs savings it has enjoyed as a result of the bundled offer.

Telstra's ownership of the CAN as an essential input into many telecommunications services is a key reason why bundling of services by Telstra raises entirely different trade practices issues than bundling of the same services by other service providers.

Gans and King identify the following conditions as being required for a vertical price squeeze:

- (a) the firm implementing the price squeeze must be integrated and involved in both the supply of the upstream input and the retail production and sale of the product using the input;
- (b) the retail-level firm that is the victim of the price squeeze must be dependent on the upstream supply of the input from the integrated firm; and
- (c) both the firm implementing the price squeeze and the victim of the price squeeze must be active competitors in the relevant retail market.²⁴

As all of the pre-conditions exist in relation to Telstra by virtue of its ownership of the CAN, the integrated firm (Telstra) may implement a vertical price squeeze by setting the price it charges for the essential downstream input (in this case, the price for access to services provided by the CAN) and the price it charges for its retail output (Telstra's own fixed-line telephony products) in such a way so that an efficient retail competitor such as AAPT is unable to acquire access to the CAN for a price that would allow it to match the retail price of Telstra's own fixed-line telephony products. This makes effectively workable retail competition unattainable.

The following comments should also be born in mind in relation to characterising a price squeeze:

A dominant vertically integrated undertaking can subject its rivals to a price squeeze in one of three ways:

1. charging a higher input price while leaving its retail price unchanged; or
2. raising the input price while leaving its retail price unchanged; or
3. reducing its retail price while perhaps also increasing the input price.

²⁴ Stephen King, *The Potential for Vertical Price Squeeze under the Proposed Foxtel,/Optus/Telstra Pay TV Arrangements*, April 2002, at page 5.

While some price squeezes may be discriminatory (1 above), others are not (2 & 3). What differentiates a price squeeze from other exclusionary pricing practices is its focus on the difference between upstream and downstream price, not whether they are excessive or discriminatory *per se*.²⁵

The scope for an integrated firm to implement a price squeeze is increased if the integrated firm is able to offer bundled products. Also, the potential for the integrated firm to implement a price squeeze increases significantly when the non-integrated firms are only able to offer some of the products in the bundle. This is because, as noted above, the integrated firm can use bundling to limit the available market for non-integrated competitors. Not only is the size of the available market reduced, the available market left for the pure telecommunications providers will be limited in terms of the amount each customer has available to spend on telecommunications services. This will ultimately reduce the ability of non-integrated competitors to compete with integrated suppliers such as Telstra.

King proposes ways of addressing the trade practices issues that arise where Telstra bundles products, including:

- placing the onus on Telstra to justify its bundled prices; and
- taking a prospective approach to bundled pricing, by the Commission checking bundled prices before the relevant bundle can be offered to customers or quickly responding to complaints about anti-competitive pricing as soon as complaints occur.²⁶

Gans and King have suggested as an alternative to imputation testing, namely that Telstra be required to account for the discounts associated with its bundles by reference to costs savings it has enjoyed by reason of bundling.²⁷ Such cost savings may be:

- savings in recording a number of different services in one bill;
- savings in marketing and advertising of a bundle, rather than individual services comprising the bundle; and
- reduction in call centre expenses.

3.8 Damage to competition in the long distance telephony market

Bundling by Telstra of fixed-line services damages competition in the national long distance market and other relevant markets.

In order to compete, competing service providers, such as AAPT, have generally provided services by acquiring originating and terminating access services and wholesale long distance services from Telstra and providing these services to customers using the service provider's own switching infrastructure.

²⁵ Case Associates, "Price Squeezes" Casenote Competition Issue 26, July 2002.

²⁶ Annexure A, at pages 1, 4.

²⁷ See the comments by Stephen King in Annexure A to this submission and his previous paper: J Gans and S King 'Achieving Price Transparency in Bundles', 21 October 2002.

While owning some key components of the infrastructure required to provide a long distance telephony service provides service providers with some degree of independence from Telstra, they all still depend on obtaining access to Telstra's CAN.

Paul Budde's paper, *Australia - Industry - Competition Issues* notes that:

Despite the assistance of the international companies mentioned above [the owners of Optus, AAPT, Orange, Vodafone and OzEmail], none of them has been able to break the power of Telstra and most have scaled down their investments in Australia, ...

Another sad story is the long-distance telephony market, once the jewel in the competition crown. Telstra is clawing back market share here, as it is making it impossible for its wholesale customers to make a profit, margins are often well below 10%.²⁸

While AAPT understands that Telstra has lost some market share in the long distance telephony market and other relevant markets since 1997, Telstra has managed to retain a high market share in all relevant markets despite the existence of varying levels of competition in those markets. This is indicative of the substantial market power Telstra still exerts in all telecommunications markets and particularly in the fixed-line telephony markets because of its control of the CAN.²⁹

A key factor in the ability of service providers to compete with Telstra in the supply of long distance telephony depends, to a large extent, on a providers' ability to attract customers to pre-select their long distance calls to them (and therefore use non-Telstra infrastructure). Bundled offerings by Telstra which include a requirement that the customer agree to pre-select all of its fixed-line telephony to Telstra, such as the current Telstra Rewards Option program, are directed at the very heart of this strategy. Such bundles affect the ability of service providers such as AAPT to compete and may in the medium term affect their commercial viability. The blunting of vigorous and effective competitors such as AAPT in fixed-line telephony markets means that telecommunications markets are likely to become less competitive which would inevitably lead to an increase in the prices of telecommunications services.

3.9 Viability of pure telecommunications providers

Telstra's inclusion of non-telecommunications services is likely to push pure telecommunications providers into a declining market of low spend customers.

The inclusion of non-telecommunications services (for example subscription television services) in the Telstra Rewards Options program will affect pure telecommunications providers by making them vulnerable to a price squeeze implemented by Telstra in respect of the access prices to the CAN. This, combined with the likely uptake of the Rewards Options program (because of

²⁸ Paul Budde, *Telecommunications and Information Highways: Australia-Industry-Competition Issues*, (www.budde.com.au), section 3.

²⁹ See section 5.4 above.

the incentives offered) and the reduction of customer churn that will follow because of the incentives to remain with Telstra, will be detrimental to the ability of pure telecommunications companies to compete with Telstra in the medium to longer term and may result in further rationalisation of the industry.

AAPT recognises that the Commission's analysis of the effect of a bundled package is on the process of competition and not competitors. In this regard, a decrease in the ability of telecommunications players to compete will only increase Telstra's market power and ability to act independently of the market, and rationalisation will have the result of removing competitive forces that they exert on the industry altogether.

Given the way the market is trending, we can expect the uptake of Telstra's non-telecommunications services to increase. Therefore, bundles such as the Telstra Rewards Options program will push pure telecommunications providers who are unable to bundle their services with an attractive non-telecommunications service into a declining market of lower spending customers. In the longer term this will

4. CURRENT BUNDLING IN THE INDUSTRY

4.1 AAPT's response to the Commission's comments

AAPT agrees with the Commission's observations in relation to current bundling in the Australian telecommunications industry³⁰, and in particular that:

- bundling is a growing retail practice and an increasingly important means of providing services in the telecommunications industry;
- retail bundling strategies focus on specific customer groups; and
- Telstra and Optus use bundling as a retail growth strategy.

AAPT also considers:

- current bundling practices, particularly those of Telstra, need to be viewed both in historical context and in the light of Telstra's conduct in wholesale markets; and
- bundling, particularly by Telstra, is a concerted retention strategy not merely a growth strategy.

4.2 Historical context in which current bundles are offered

A feature of Telstra's bundled packages is the requirement for customers to acquire fixed-line services, the market in which it enjoys overwhelming dominance.
--

A summary of bundled packages offered by Telstra follows:

³⁰ ACCC, *Bundling in Telecommunications Markets*, An ACCC draft Information paper, January 2003, at pages 4-6.

- **March 2000**
bundle of services: basic access, local calls and pre-selection for long distance and fixed-to-mobile
incentive: lower call price caps for long distance and introduction of 15¢ neighbourhood calls
- **September 2000**
bundle of services: fixed-line services, internet, mobiles
incentive: Rewards (5% or 10% discount on eligible charges); Relationships (25% or 50% discount on calls between mobiles and fixed-lines on the one bill); Rewards anniversary (after 12 months a further 15% off eligible calls)
- **August 2002**
bundle of services: neighbourhood calls removed from all unbundled offerings
incentive: Rewards anniversary discount withdrawn
- **November 2002**
bundle of services: fixed-line services, internet, mobiles, pay TV
incentive: Rewards, Relationships and neighbourhood calls

AAPT notes:

- Telstra has progressively broadened the scope of the bundle it offers. A fundamental feature of Telstra's bundled packages is the requirement for customers to acquire local calls and basic access or line rental from Telstra. As the Commission is aware, Telstra currently has around an 80% market share in the national local telephony service market³¹ and owns the only ubiquitous CAN in Australia;
- Telstra BigPond ADSL is not yet included in the bundle, but Telstra has indicated it plans to do so by mid-2003 and overcome any regulatory hurdles; and
- new subscribers to pay TV must take a 6, 12 or 24 month contract. Customers are therefore effectively locked into the bundle for the above contract periods.

5. LEGISLATIVE PROHIBITIONS ON BUNDLING

5.1 Application of Part IV and XIB of the Act

AAPT agrees with the Commission that bundling may contravene sections 45(2), 46 and 47(2) and (3) in Part IV of the Act, and the competition rule in Part XIB of the Act.

Utilising the principles discussed above on the potentially anti-competitive impacts of bundling, the following considers the specific application of the Act's provisions to Telstra's current bundling behaviour. Suggestions are

³¹ Productivity Commission, *Telecommunications Competition Regulation* 21 September 2001 at pages 99, 114: Telstra accounts for around 95% of local access services, 81% of retail local telephony revenue and 83% of retail local services.

also made in relation to the Commission's powers under the Act to gather information to assist in its assessment of bundled offers.

5.2 Section 45 and the competition rule: anti-competitive arrangements

Section 45 can apply to contracts between a supplier and an acquirer (with the exception of exclusive dealing). Contracts can be aggregated to assess the impact of a bundled offering.

Section 45 of the Act operates as a 'catch all' provision, covering both vertical and horizontal arrangements, subject to express exceptions. A possible relevant exception here is section 45(6) which precludes conduct that falls within section 47 from being considered under section 45. Unless the contract falls within section 47, the provision offering the bundle falls to be considered under section 45 of the Act.

AAPT notes that the Commission has recently stated in its report to the Senate: *Prices paid to Suppliers by Retailers in the Australian Grocery Industry*, that section 45 can apply to contracts between a supplier and an acquirer (with the exception of exclusive dealing).³² The commentary of Heydon also supports the view that section 45 of the Act applies to vertical arrangements:

One particular aspect of this breadth of ss45-45C is that where conduct in the nature of arrangements is, perhaps for technical reasons, not within s47 (exclusive dealing), it will fall back for consideration under s45.

Section 45(4) of the Act enables one to aggregate all the contracts to which the corporation, such as Telstra, is a party, in determining whether the purpose, effect or likely effect of the contractual provision is to substantially lessen competition in a market. Relevant to this assessment in Telstra's case is the fact that over 80% of retail local services are supplied by Telstra³³ and Telstra believes that a third of its customers will take up a bundled offering.³⁴

Telstra's Standard Form of Agreement contains a provision in relation to offering a bundle under relevant discounts. Telstra's behaviour in connection with this provision could have the purpose or likely effect, of substantially lessening competition in a number of telecommunications markets in breach of section 45(2) and so should be considered further by the Commission.

5.3 Section 46 and the competition rule: misuse of market power

Telstra has a substantial degree of power in the national retail market for the supply of local telephony services.

AAPT considers that Telstra has a substantial degree of power in a range of telecommunications markets and potentially has taken advantage of that power:

³² ACCC report to the Senate dated September 2002 at page 48.

³³ Productivity Commission, op cit.

³⁴ Dr. Switkowski at the Salomon Smith Barney US ENT Conference 8 January 2003.

- for the purpose of deterring or preventing AAPT or other carriers or CSPs from engaging in competition in one or more telecommunications markets (in breach of the misuse of market power prohibition in section 46 of the Act); or
- with the effect or likely effect of substantially lessening competition in one or more telecommunications markets (in breach of the competition rule).

A relevant market in which to assess Telstra’s market power for the purpose of sections 46 and the competition rule is the national retail market for the supply of local telephony services.

AAPT believes that Telstra’s purpose in implementing its bundled offers and its associated conduct should be investigated by the Commission. Telstra’s purpose has been in part articulated by Telstra executives³⁵, and inferences have been made as to Telstra’s purposes by numerous investment analysts.

5.4 Sections 47(2) and 47(3) and the competition rule: exclusive dealing

Bundled offerings should be assessed against the exclusive dealing prohibitions.

Telstra’s conduct should be examined to determine whether Telstra gives a discount in relation to the supply or proposed supply of telecommunications services on condition that customers will not, or will not except to a limited extent, acquire telecommunications services directly or indirectly from AAPT or other carriers or CSPs. The likely effect of such conduct would be to substantially lessen competition in one or more telecommunications markets.

Also, Telstra’s conduct should be examined to determine whether Telstra refuses to supply certain of the telecommunications services in its bundle for the reason that the customer has acquired services available in the bundle from another provider with the same likely effect.

In determining whether there has been substantial lessening of competition, section 47(10)(b) of the Act permits aggregation of the specific exclusive dealing conduct with ‘other conduct of the same or a similar kind’.

In AAPT’s view, Telstra’s conduct is likely to contravene section 47 of the Act. However, if it does not for a technical reason meet the element of being provided ‘on condition’, then as discussed above the conduct certainly falls to be assessed under section 45 of the Act which has the same competition test.

5.5 Substantial lessening of competition

In assessing whether conduct is likely to substantially lessen competition, it is important to adopt the correct counterfactual scenario – a “future with or without test” is required rather than a “before and after” test.

Where a bundle is varied, the assessment of the new offering should consider the impact of the whole bundle, not merely the incremental impact of the proposed variation.

³⁵ In the bundling information paper the Commission refers to public statements by Telstra regarding its bundling strategy. Section 46(7) enables relevant purpose to be inferred from relevant circumstances.

AAPT considers that in examining the effect of a bundling proposal it is important that the competition analysis adopts the correct counterfactual scenario.

The courts have stated that the correct counterfactual for examining the impact of conduct on competition is as follows. This approach should also be adopted when determining whether bundling conduct is likely to substantially lessen competition in breach of sections 45 or 47 of the Act and the competition rule:

To apply the concept of substantially lessening competition in a market, it is necessary to assess the nature and extent of the market, the probable nature and extent of competition which would exist therein but for the conduct in question, the way the market operates and the nature and extent of the contemplated lessening.³⁶

Any assessment of how conduct will affect competition going forward, therefore, must be undertaken by comparing what the relevant market will look like going forward “with” the conduct with what it will look like “without” the conduct. The assessment should recognise that competition is a process and should not be undertaken on the assumption that a market will remain static.

The application of the with and without test was further explained by the Tribunal in *Re QIW*³⁷ where the Tribunal citing *Re QCMA* said at page 276:

The test is not to compare the present situation with the future situation, were the acquisition to take place: a "before and after" test. Rather the test is to appraise the future, were the acquisition to take place, in light of the alternative outcome, were the acquisition not to take place: the "future with-and-without" test.

As QCMA expressed the point (at ...ATPR 17,243):

...

Plainly we should take into account any likely changes to the business environment in which the proposed conduct would operate.

These decisions make clear that the application of the “with” and “without” test involves:

- determining what the state of competition in the relevant markets will be taking into account all relevant market factors, including all changes that are likely to take place in the foreseeable future; and
- considering what the future state competition in the relevant market will be with and without the relevant conduct.

AAPT has previously indicated to the Commission its strongly-held view that if Telstra sought to vary its Options Rewards program by adding a service or increasing a discount, the conduct would fall outside the statutory immunity

³⁶ *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd* (1982) 64 FLR 238 per Smithers J at 259-260.

³⁷ *Re Queensland Independent Wholesalers Ltd* (1995) 132 ALR 225.

that the Commission has afforded Telstra in respect of that program under the exclusive dealing notification procedure in the Act.

Telstra has indicated on several occasions that it expects to overcome by mid-2003 any regulatory obstacles associated with adding ADSL to its Rewards program.³⁸ AAPT is concerned that even if Telstra notifies the Commission of this proposed variation, in applying the with or without test the Commission should assess the impact of the whole bundle, not merely the incremental impact of the proposed variation. In doing so, the Commission should consider whether the bundle as a whole is likely to anti-competitively reduce the addressable market of competitors resulting in a substantial lessening of competition.

5.6 Information gathering powers

AAPT supports the use of the Commission's information gathering powers to assist in assessing bundling conduct.

A significant issue for the Commission is how it should go about obtaining the information necessary to assess bundling conduct. Recent industry comment has focused on the role of imputation analysis, and therefore the use of the record keeping rules to obtain the cost data necessary to conduct that analysis. Broadly, AAPT's view regarding the Commission's information gathering powers in this context is:

- AAPT agrees with the view recently expressed by the Commission that the cost data it obtains under the Regulatory Accounting Framework should be publicly disclosed;
- there are certain limitations to the tariff filing rules, in particular, the limited time frames in which the Commission has to consider the information provided; and
- the Commission should readily exercise its powers under section 155 of the Act in the context of bundling.

Each of these points is dealt with below.

Record keeping rules

Public disclosure of information used to apply imputation tests is necessary.

The Commission, in its report *Regulatory Principles for the Public Disclosure of Record-Keeping Rule Information*, has indicated that it may disclose publicly the information on which it conducts imputation testing. AAPT believes that such disclosure will promote competition and facilitate the operation of the Act.³⁹ Specifically, it will enable other industry members to assess data provided to the Commission thereby minimising the prospect of

³⁸ See Communications Day, *Telstra confirms monolith status with new bundling regime*, 29 November 2002.

³⁹ Section 151BUA(2) of the Act.

such data being manipulated. AAPT does not believe that such disclosure would, in the ordinary course, threaten the carrier's legitimate interests.⁴⁰

Tariff filing rules

The existing tariff filing rules under the Act do not enable the Commission to deal prospectively with the introduction or variation of bundling conduct

Division 4 of Part XIB of the Act enables the Commission to give a person with a substantial degree of market power, a written direction requiring that person to notify the Commission at least 7 days before imposing a new charge, varying a charge or ceasing to impose a charge for goods or services specified in the direction. AAPT believes that this power is of limited value as it does not enable the Commission to deal prospectively with the introduction or variation of bundling conduct.

Further, it is clear from the Commission's annual report for the financial year 2000-2001 that Telstra sometimes provides the Commission with insufficient notice. For example, it is there reported that on one occasion the Commission was notified of a proposed price change on the afternoon prior to the implementation of the proposal. In any event, AAPT submits that 7 days' notice is insufficient for the Commission to determine whether the conduct is anti-competitive.

Division 5 of Part XIB does not address any of these concerns.

Section 155 of the Act

AAPT supports greater use by the Commission of its section 155 powers to assess bundling conduct.

The Commission's draft information paper indicates it is considering using its powers under section 155 of the Act to acquire information relevant to an assessment of bundling conduct. AAPT supports the greater use by the Commission of these powers.

AAPT suggests that the Commission consider utilising its powers under section 155 to gather the following information in order to examine current bundling behaviour in the telecommunications industry:

- information as to changes in Telstra's costs as a result of it offering the Telstra Options Rewards program, including billing systems, advertising and call centre costs;
- information relating to the impact to date of the Telstra Options Rewards program on Telstra, including take-up and churn rates;
- documents illustrating Telstra's purpose in offering the Telstra Options Rewards program; and
- documents predicting the current and likely take up of the Telstra Options Rewards program, or other bundles in the next 6 months.

⁴⁰ Section 151BU(4) of the Act.

6. PROPOSED LEGISLATIVE REFORM

6.1 Amendment to Part XIB of the Act

AAPT recommends an amendment so as to require Telstra to notify the Commission of bundled packages and obtain its approval before offering the bundle.

(a) The need for a prospective remedy

AAPT proposes an amendment to Part XIB of the Act to ensure that the Commission can address bundling prospectively. In support of such an amendment AAPT notes that:

- the Commission emphasised to the Dawson Review the ‘extreme importance’ of quickly stopping anti-competitive conduct in the ‘new economy and the global market place’,⁴¹ and went on to note that delay in stopping anti-competitive conduct results in irreversible damage and difficulty in fashioning appropriate remedies;⁴² and
- the competition rule in Part XIB is applied retrospectively so that Telstra is encouraged not review its position until the Commission has issued a Part A competition notice to it. Telstra is not liable to pay damages or a pecuniary penalty for conduct in breach of the competition rule that is engaged in prior to the issue of such a notice. However, if Telstra’s conduct is anti-competitive, the damage to competition may be irreversible.

(b) The proposed amendment to Part XIB

AAPT therefore proposes an amendment to Part XIB to require that:

- Telstra, before it offers a retail bundle or seeks to vary a bundle, notify the Commission and obtain its approval; and
- Telstra is precluded from offering the bundle until the Commission determines that the offer is not likely to substantially lessen competition in a telecommunications market.

6.2 Amendment of Part XIC of the Act

AAPT recommends Telstra should be required to supply at wholesale any ‘bundle’ that it offers at retail containing a service delivered by means of its fixed network and each component of that bundle.

⁴¹ ACCC submission to the Dawson Review of the *Trade Practices Act 1974* dated June 2002 at page 96.

⁴² As the Productivity Commission noted, *given the present state of competition, there is a need for regulatory provisions to facilitate speedy action against alleged anti-competitive conduct in the telecommunications sector. The Commission continues there is a special danger in the telecommunications sector that anti-competitive conduct, where it occurs, could have the effect of foreclosing entry into newly developing market segments*, Productivity Commission 2001 *Telecommunications Competition Regulation*, Report No. 16, AusInfo, Canberra, at page 172.

(a) The need for a remedy at wholesale

AAPT considers that it is in the interests of a competitive market place for AAPT and other providers of fixed-line services to have access at wholesale on commercially reasonable terms to the services in Telstra's retail bundling offers. This will enable competition to be promoted in downstream markets.

AAPT submits that Part XIC of the Act should be amended to allow for this. Such an amendment would go a considerable way towards addressing the potentially anti-competitive effects of bundling.

(b) Proposed amendment to Part XIC of the Act

AAPT submits that Part XIC of the Act be amended so that:

- Telstra is required to offer to access seekers a wholesale service delivered by means of Telstra's fixed network where Telstra is supplying that service in a bundled offer at the retail level. Telstra would only be required to do this if the Commission determines that the likely effect of Telstra's bundled offering is to substantially lessen competition in a market. A bundle would be defined to mean a product offered by Telstra which comprises the supply of two or more telecommunications services on terms and conditions which are different to those which apply if the end user acquires those services separately, while each of the telecommunications services would form a component of the bundle.

AAPT makes the following additional points regarding the need for this amendment:

- Part XIC of the Act focuses on individual carriage services which can be used by access seekers to supply downstream carriage services and/or content services. It requires amendment to reflect the emergence of bundling as a significant retail practice;
- recent disputes involving the local carriage service illustrate the manner in which Telstra can game the regulatory regime through the offer of a bundle. As the Commission is aware, Telstra offers local carriage services together with line rental. Only local carriage services are declared services and therefore Telstra charges access seekers its retail price for line rental. To deal with this, the Commission took into account the retail costs of supplying line rental in determining access prices for the local carriage service. The Commission's approach of dealing with Telstra's bundling on that occasion, may not be available to the Commission in other contexts, particularly where some of the services in the bundle are not declared services;
- AAPT and other of Telstra's competitors, rely extensively on Telstra for access to the essential inputs necessary for the supply of downstream services. Accordingly, it is not always

open to Telstra's competitors to offer a bundle of services comparable to Telstra's, both in relation to quality and price; and

- the proposed amendment would not stifle innovation or investment. AAPT and others have every incentive to differentiate their products and services from those offered by Telstra. To the extent AAPT and others are able to acquire additional customers and better assess likely demand characteristics, this would facilitate decisions to roll out further infrastructure.

(c) New Zealand's approach

Set out below is a description of the manner in which the *Telecommunications Act 2001* (NZ) guarantees at wholesale access to the component retail services offered by means of Telecom New Zealand's fixed network as part of a bundle of retail services. The amendment to Part XIC of the Act proposed above is derived from the New Zealand approach.

The New Zealand Telecommunications Act contains an access regime requiring Telecom to provide access to defined designated access services. On the application of an access seeker or an access provider, the New Zealand Commerce Commission may make a determination as to the terms and conditions on which a service must be supplied.⁴³

Schedule 1 to the Telecommunications Act sets out the designated access services as well as the access and pricing principles which apply. Relevantly, a designated access service which Telecom is obliged to supply at wholesale includes a retail service that is or has been offered separately by Telecom to end-users by means of its fixed telecommunications network and is offered by Telecom to end-users as apart of a bundle of retail services. Telecom is only required to supply such a service in markets in which it faces limited competition for that service (or is likely to face lessened competition) and if the effect of the bundled price is likely to significantly reduce the ability of an efficient rival to contest the market.

⁴³ Sections 27 and 30 of the Telecommunications Act 2001 (NZ). A determination made under section 27 may include reference to price.

Annexure A



Comments on “Bundling in telecommunications markets: An ACCC draft information paper”

Stephen King

Melbourne Business School, University of Melbourne

February 14, 2003

The analysis here represents the views of CoRE Research Pty Ltd (ACN 096 869 760) and should not be construed as those of AAPT.

www.core-research.com.au

AAPT has asked me to comment on the ACCC draft information paper on “Bundling in telecommunications markets” (January 2003). In my opinion, this draft information paper represents a significant step forward in the regulation of anti-competitive conduct in the Australian telecommunications industry. It is highly desirable for the ACCC to continue this regulatory process while noting the potential problems with bundling and imputation tests. In particular, in my opinion the Commission needs to address the practical issues of implementation more carefully and might wish to place some of the onus for showing that bundled offerings are not anti-competitive back onto Telstra.

In the remainder of this note I present a number of specific comments on both the ACCC draft information paper and on the associated NERA report “Imputation tests for bundled services – a report for the Australian Competition and Consumer Commission” January 2003.

1. It is not completely clear in the Draft Information Paper whether the Commission is taking a retrospective or a prospective approach to bundled pricing. On p.14 they note the importance of “likely future take-up of the bundled services” and on p.20 they note how tariff filing can be used as a check on pricing. But on p.21 they ask Telstra for “the total number of new customers obtaining each bundled offering”. In my opinion, it is important for the Commission to adopt an upfront approach, checking bundled prices before the relevant bundle can be offered to customers or quickly responding to complaints about anti-competitive pricing as soon as those complaints occur.
2. In its draft paper, the Commission pays little attention to the administrative difficulties associated with imputation tests for bundles. It places significant faith in the record keeping rules and regulatory accounts. In my opinion, this faith is likely to be overstated in practice.
3. Many of the administrative difficulties relate to gaining the correct information to be used in an imputation test. Gans and King (2003) “Achieving price transparency in bundles”, 21 October, p.8-9, note the difficulties in gaining the cost information to apply imputation rules to bundled products. Their paper suggests an alternative simpler approach where Telstra must justify its bundled prices on the basis of provable cost savings. The ACCC has not canvassed this or other alternative approaches that might place the burden of proof back on Telstra.
4. I have a number of relatively minor concerns relating to imputation rules and costs in the draft paper. For example, if there are common costs, there is no unambiguous imputation rule. The Commission appears aware of the difficulties and notes them on p.17, but does not really state how it will address these issues.
5. At the same time, the Commission does not clearly distinguish between marginal, incremental and average costs. The difference between marginal and incremental costs is unimportant in a single product case but is crucial for bundled products where there are common costs of production.

6. I now turn to the NERA report “Imputation tests for bundled services”. This report is competent but tends to be relatively conservative. For example, when considering single products and costs of ‘own supply’ it takes the Hausman and Tardiff approach. This is criticized by King and Maddock (2002) “Imputation rules and a vertical price squeeze”, *Australian Business Law Review*, 30, 43-60 as being too favorable to the firm with market power. The report skates over some of the difficulties in imputation tests and bundled products, particularly relating to common costs.
7. In particular, s.4.3 of the NERA report, suggests a number of alternative approaches for dealing with bundled products where the bundling firm faces no competition (or limited competition) on one product in the bundle. These approaches are not exhaustive nor need they be exclusive. For example, when dealing with products sold in different markets and involving common costs, issues of ‘cost allocation’ immediately arise. At one extreme, all common costs can be allocated to the product that is sold ‘outside’ the market. At the other extreme, all common costs can be allocated to the product ‘in the market’ and open to competition. These lead to very different results. An allocation of common costs is implicit in equations 5 and 6 of the NERA report, but is not made explicit. To see this consider equation 6 and suppose that all costs of x and y are common costs. Let these common costs be \$1 per unit of x and y . Telstra has a monopoly in y and bundles it with x . For simplicity, assume access is irrelevant for product x . So any firm wishing to sell product x must charge at least \$1 per unit (and it cannot sell y). By equation 6, Telstra can charge any price for the bundle that is at least \$1.⁴⁴ So then a customer can either get x and y from Telstra at a price of \$1 or can get x alone from a competitor at a price of \$1. In this test, all the common costs are loaded onto product y so Telstra can set an incremental price of \$0 for x . Now this may or may not be a bad thing – but it certainly means that there will not be competition in the provision of product x .
8. Note that equation 5 also involves a common cost allocation, but this allocation depends on Telstra’s prices and expected sales. For example, following on from the example in point 7, suppose that Telstra set a price of \$0.50 on product y by itself. Then by equation 5, Telstra can set a price of \$0.50 or more for the bundled product. If Telstra did set a price of \$0.50 for the bundle then it would make a loss overall. Assuming that the Commission would catch such a loss and deem it anti-competitive, and assuming equal numbers of ‘ y alone’ and ‘bundled’ sales are expected, the minimum bundle price that would cover common costs is \$1.50. But if Telstra raised its y -alone price to \$0.80 it could lower its bundle price to \$1.20. If it raised its y -alone price to \$1, then equation 5 would start to bite and the bundled price would need to be at least \$1. Any further rise in the price of y -alone would lead to a

⁴⁴ In this simple example, $C_y = \$1$, $A_{x|y} = 0$ and $C_{x|y} = 0$.

dollar-for-dollar increase in the required bundled price. Again, the problem for competitors is that Telstra can effectively make the competitive product x free to any customers wanting to buy x and y in this simple example.

9. The problem of common cost allocation means that bundled imputation tests will always be more subjective and more difficult than single product tests. It also means that care must be taken to both prevent anti-competitive pricing and to allow Telstra to recover legitimate costs.

In conclusion, I believe that the ACCC draft information paper is an important step to improve the competitive Australian telecommunications environment in the presence of bundled products. However, in my opinion further work is required particularly relating to the administration of any imputation tests and the onus on Telstra to justify its bundled prices. In particular, bundles need to be checked 'in advance' rather than after competitive harm has occurred.