Response to National Broadband Network Points of Interconnect Discussion Paper

November 2010

Introduction and Summary

The CCC welcomes the opportunity to respond to the ACCC paper on points of interconnect (PoI) for the NBN.

The CCC considers the decision about the locations of points of interconnect to be one of the most profound of the network architecture decisions that will be made in relation to the NBN because of the important implications for competition in adjacent vertical and horizontal markets. It is not a simple technical decision, but one that shapes the competitive environment for the foreseeable future.

The Government has repeatedly said that a primary objective of its reforms of the communications industry has been to resolve industry structures that have resulted in poor competitive outcomes for all Australian consumers.

The CCC's longstanding mission is to promote competition in the communications industry to the greatest extent possible. For this reason the CCC recommends that the ACCC reject the preferred option of NBNco. The CCC believes that this option is logically flawed. Further, it would result in a loss of competition in transmission or backhaul markets, and that this would have serious implications for retail competition over time.

The CCC believes that the maintenance of the separate regulatory treatment of the last mile and transmission markets should guide the Commission in considering the preferred approach of NBNco. However, it is incumbent on the Commission to more actively address outstanding matters in the regulation of transmission services, most notably establishing pricing principles for regulated transmission services, in order to support a more suitable model by which the NBNco can set above establishing its approach to PoIs.

The NBNco Preferred Model: Is it Logically Consistent?

The CCC submits that there are flaws in the basic reasoning behind the NBNco preferred PoI option. Given the risk to competition in adjacent markets from the NBNco preferred option, it is important that these issues are considered, as they go to the basis upon which NBNco has proposed its radical model for locating PoIs.

Flaw 1. Retail Price Parity Reasoning

The most important area where the CCC submits NBNco's reasoning is flawed relates to retail pricing parity and what must be done to achieve it.

NBNco indicates that its preferred model is a response to the Government's policy ambition to create an environment where regional consumers are not disadvantaged against consumers in capital cities. By this it implies that it must create the conditions in wholesale markets that lead to there is national <u>retail</u> price parity. NBNco seeks to create a national uniform <u>wholesale</u> price environment to support this retail outcome.

For this reason, NBNco proposes to have PoI's only in five capital cities, with the transmission/backhaul component incorporated with the last mile access price into a single service. In this way, NBNco proposes to ensure that the wholesale price for a service within a capital will be the same as the price for a service to a remote or regional location connected to that capital.

However, the CCC submits that the PoI architecture that NBNco proposes does not in fact result in national uniform wholesale prices. NBNco proposes that retail service providers connect with NBNco in five capital cities to pick up individual services, but RSPs then acquire inter-capital transmission separately to link these services to interstate and international peering points.

These links would be acquired from other providers. The costs and prices of transmission across these interstate routes varies. For example, the cost of transit from Sydney to Perth is substantially different to the cost Melbourne to Sydney.

The result of this is that the total wholesale cost to an RSP of servicing a customer in Western Australia will be different to the total wholesale cost of servicing a customer on the East coast. This means that, if, as NBNco implies, uniform wholesale prices are required to support uniform retail prices, the conditions for uniform retail prices have not been met by NBNco's preferred approach.

In order to overcome this and genuinely deliver uniform national wholesale pricing, NBNco would need to incorporate all inter-capital transmission routes into its wholesale service, as well as all intra-state routes.

Flaw 2. Determining which transmission routes are competitive. How Did NBNco Choose Where to Draw Its Business Boundaries?

This raises the question as to why NBNco chose to incorporate all transmission routes within states and interstate routes between some states and territories (ACT, Tasmania, NT), but to leave transmission prices between Sydney, Melbourne, Brisbane, Adelaide and Perth to the market.

NBNco has indicated to the CCC that it chose this approach on the basis that these five routes were competitive. It agreed, however, that there were cost and prices differences between even those five cities.

Further, this implies that all other routes are not competitive. This includes all those routes that have been exempted from declaration by the ACCC on the basis that they are competitive.

The NBNco paper does not clarify what methodology it applied in making these decisions, and in subsequent discussions with the CCC, NBNco has indicated that it did not develop such a methodology.

The result is that NBNco has not established if or how it can conclude that all inter-capital routes that form the boundaries of its preferred option are competitive. This is an unsound basis for determining network boundaries. Without any evidence, how can it be concluded that, for example, the route Sydney-Perth is competitive, while the route Sydney-Canberra is not? Or that routes between Brisbane and Melbourne are competitive but Newcastle to Sydney are not.

In effect, NBNco has sought to move the boundary of its natural monopoly upstream to absorb transmission services because it is not in a position to resolve the difficult regulatory questions pertaining to transmission markets, but has done so on a subjective basis.

Is the NBNco Preferred Approach Reasonable?

The CCC is deeply troubled by this approach, although it accepts that NBNco is not the agency that is primarily tasked with defining the limits of competition on behalf of the Government. While this pragmatic approach is understandable from the perspective of NBNco's desire to get on with the task of building its network as quickly as possible, it is not consistent with good public policy.

However, the CCC submits that the decisions made by NBNco about where it places its PoIs and the reasoning behind these decisions are fundamental to the economic regulation of the communications industry.

In effect, these decisions are establishing boundaries not just for NBNco's business, but also for setting the limits of RSP and other wholesale activity in what historically have been seen to be competitive or potentially competitive markets.

NBNco's decisions will have profound implications for both past and future investments in a market that public policy and regulatory settings had indicated were understood to be contestable or potentially contestable. It would be poor regulatory practice to allow these important decisions about a change in direction of policy and regulatory signals to be made without a robust examination of the underlying principles.

Effects of NBNco Proposal and Public Policy Principles

The NBNco preferred option is likely to mean that the market for backhaul outside of intercapital routes is no longer open to competition. This is acknowledged in the discussion paper to the extent that it seeks advice on the potential stranding of assets. It is unclear how future entry into intracapital transmission market would be possible. It is unlikely that it would occur in the foreseeable future even if it were possible in an environment where the present operators had withdrawn to accommodate the NBNco.

Further, the proposal is likely to result in the commoditisation of intercapital transmission markets. This would discourage future entry into these markets. It is possible that participants would in fact exit these markets over time.

In other words, the model is one that forecloses markets to competition, quite likely permanently.

As discussed below, the CCC submits that the test that the Commission must apply in these circumstances is properly and necessarily a tough one.

Is the NBNco Proposal Best for Competition?

NBNco argues that its proposal will result in the most active retail competition because it will allow many retailers to participate in the market to provide end user services. This is because the barriers to entry in the retail market will be low.

The CCC does not accept that the simplest market model is necessarily the best to meet the LTIE test.

The CCC has repeatedly argued that structural reform of telecommunications should result in competition at numerous levels. While the CCC has argued that there are natural monopoly elements in the network, it has argued that structurally separating these elements should result in robust competition at wholesale and retail levels. For example, wholesalers would be expected to package services from the structurally separated access network owner with their own services to tailor products for pure retailers. This market evolution is evident in the UK, post functional separation. This outcome would maximise competitive tension and benefits to consumers.

However, the PoI model preferred by the NBNco and the subsequent loss of competition and competitors would likely seriously retard the development of wholesale service competition.

These implications raise profound questions that must be at the heart of the ACCC's deliberations about the NBNco's PoI approach. The CCC submits that it is unprecedented in recent history for the Government, directly or through a commercial agency, to enter a market the Commission regards as competitive and, in so doing, foreclose it to competition.

The circumstances under which this could be considered reasonable must at the very least be thoroughly considered against the history of public policy and regulatory activity in the market involved.

The CCC submits that there are threshold questions that must be answered before such an action can be justified.

The CCC believes that it is reasonable for NBNco to operate as a regulated monopoly in the last mile market because, as discussed above, this market has natural monopoly characteristics. The history of 20 years of failed attempts to create competition in this market has proved persuasive to the Government.

However, the NBNco discussion paper does not make out a case that the transmission market is a natural monopoly outside of intercapital routes, while proposing a remedy that would imply that they are.

Before the ACCC could seriously contemplate such a strategy, it must be established whether the NBNCo's activities truly exhibit natural monopoly characteristics. As NBNco acknowledges, competition analysis aimed at determining appropriate boundaries of competitive/non-competitive behaviours are questions for the Commission. NBNco is clearly not equipped to make these judgements.

Accordingly, if the Commission is not satisfied that these routes are natural monopolies, it is difficult to see how it can be consistent with the LTIE for the Commission to allow them to be integrated into the NBNco last mile services if this forecloses competition.

NBNco also has not established if or how it has concluded that all inter-capital routes are competitive. Without any evidence, how can it be concluded that, for example, the route Sydney-Perth is competitive, while the route Sydney-Newcastle is not?

Clearly, then, a robust definition of competitiveness in the transmission markets is required. If the NBNco believes that the Commission's analysis in its past deliberations on exemption applications for various routes has been deficient, it should explain why it has formed this view.

Separation of Regulation of the Transmission and Last Mile Networks

The CCC submits that the policy and regulatory framework has for many years treated the markets for last mile services and transmission/backhaul as separate, and requiring separate policy approaches.

The set of Government policy actions that has resulted in the establishment of the NBN is predicated on the fact that the last mile for fixed line services using a fibre-based access technologies is a natural monopoly. The Government proposes to regulate the NBNco consistently with this principle, requiring it to remain a wholesale-only business with its prices subject to ACCC regulation.

In this context, the CCC submits that the "last mile" in a fibre access environment consists of what the ACCC/NBNco discussion paper describes as the Fibre Serving Area, which is the paper indicates is in some ways equivalent of the Exchange Service Area in the copper access network environment.

In contrast to last mile access regulation, the regulation of transmission markets, as noted above, has been predicated on the assumption that these are potentially contestable markets. Policy and regulation has been focused on facilitating entry.

It has been determined by the Commission that competition has, in fact, developed on numerous routes. If prices do not appear to be trending toward cost in any particular market downstream of capital cities, this might be an indicator of market failure on that and other routes. However, this does not immediately justify imposing a "monopoly solution" across all markets downstream of inter-capital routes.

It certainly does not follow that markets that are not today competitive are natural monopolies – market failure might flow from a range of causes or combination of effects including duopoly structure, price signalling, anti-competitive conduct, or irregularities arising from recent investment or lack of co-ordinated government interventions.

The approach of successive Governments to resolving the continuing problems of high prices on regional routes has been to stimulate competitive entry. The present Federal Government has most recently intervened directly to inject competition through the Regional Backbone Blackspots Program. This program invested $250 million dollars to support privately rolled out and operated new transmission infrastructure in competition with Telstra's incumbent transmission service across about 6000km of mainland Australia.

The CCC believes that the preferred approach of NBNco to establishing PoI's would imply that the last mile extends to five capital cities, and that this would be a radical departure from established policy and regulatory assumptions. This is despite the fact that the NBNco network architecture implies that there is potentially a “natural” last mile termination point lower in the network.

The CCC submits that it is premature to make such a departure from established policy and regulatory paths without a thorough examination of the alternative approaches that might deliver the Government’s various and potentially competing policy directions in a way more consistent with both the past and with good regulatory practice.

What Determines Competitive Routes?

Before a commitment to past practice is jettisoned, it is important to establish whether it has no place. This requires determining whether transmission is a potentially competitive market, or if it is indeed a natural monopoly that should be treated as an extension of last mile monopoly.

A universally accepted definition of what constitutes a competitive transmission route has proved elusive. However, the CCC submits that this is a task that the Commission should undertake to finalise immediately as the first step in developing a more robust approach to deciding where NBNco should deploy its PoIs.

The Commission has recently adopted a more pragmatic approach to developing pricing principles for access services, and departed from the TSLRIC/optimised replacement cost approach.

The CCC submits that the Commission should similarly take a pragmatic approach to using a combination of its past methodology (counting the number of competitors on a route) and market inquiries as to the pricing outcomes on different routes, including inter-capital and intra-capital routes previously exempted and intra capital routes still regulated.

The outcome of this work is a first step in determining whether there are ANY routes that are competitive. If the Commission concludes that transmission is a natural monopoly outside of capital cities, it may be that the proposed NBNco approach is justified.

However, in the absence of this evidence, the NBNco preferred approach is too great a departure from established Australian and international regulatory practice to be acceptable.

Satisfying the Government’s Position on Uniform Pricing and Other Policy Settings

The CCC submits that the Government’s position on uniform national pricing of NBN services is open to interpretation.

The Government is clearly desirous of achieving uniform retail pricing. However, there are various tools for achieving this, including direct retail regulation, regulation of wholesale markets regulation of wholesale prices and also subsidy, particularly in areas of natural or effective monopoly.

NBNco proposed approach confuses several of these approaches and, as discussed above, will not necessarily achieve the desired outcome of UNWP. At the same time it would displace existing investment and likely discourage future efficient investment. In turn, this will likely lead to greater price disparity on non-NBNco controlled routes and higher internal NBNco costs over time.

The CCC believes that the Government has consistently and repeated discussed the need for the public to invest in a fibre replacement for “the aging copper network”. These references extend back to the period when the present Minister was the Opposition spokesman on communications. The discussion of the aging copper network is clearly a reference to the last mile bottleneck from local exchanges or their equivalent downstream to the customer premises.

Wholesale pricing of the unbundled local loop service on the copper has been geographically de-averaged because it was assumed that competitive entry to the last mile was possible, and that efficient investment was best encouraged by prices that reflected actual costs as closely as possible.

However, as discussed above, the NBN policy environment assumes that the fibre based access network will be a natural monopoly, therefore any alternative investment would not be efficient.

The CCC therefore interprets the Government’s desire for uniform retail pricing to reference the price of the service to the first connection point that looks most equivalent to the copper termination point in the existing CAN. The NBNco has repeatedly indicated that it can design the network to accommodate any proposal required. This may be, for example, the CSA connection points that NBNco proposes under its option 4 could be a reasonable point to regard as the termination of the last mile.

This leaves unresolved the problem of the large disparity in pricing between regional and metropolitan areas for transmission services. The CCC believes that the price disparity on transmission routes has two components. Firstly, there is clearly some cost differential based on capacity and distance. Secondly, there is clearly a price difference based on the lack of competition on some routes.

The CCC proposes that the objective of removing price discrimination against regional consumers requires that monopoly rents are first stripped out of transmission route prices on uncompetitive routes.

This requires the ACCC to establish pricing principles and determine prices on specific routes that it identifies as uncompetitive. While this has proven a problem that the Commission has found insurmountable in the past, there are signs that the Commission is resolving many of the pricing principle methodologies. The Commission should soon be able to move quickly to establish initial prices, and to be able to refine these prices over time as it continues to gather more market intelligence and refine its methodologies.

Once cost-reflected regulated prices are established to strip monopoly rents from prices on uncompetitive transmission routes, other public policy tools could be applied to strip out the effects of geographic and capacity inequalities. For example, the CCC would suggest that an equalisation levy could be considered to transparently cross-subsidise routes. Alternatively, the Universal Service Obligation could be considered as one mechanism that could be used to subsidise routes for regional consumers.

This approach need not preclude future entry into transmission routes. Indeed, it could stimulate entry into potentially competitive markets by making transparent the cost to NBNco of providing transmission services. An entrant that believed it was able to build alternative infrastructure and deliver the transmission service at a lower price should be entitled to claim a lower cross-subsidy levy, creating an incentive for NBNco to encourage entry in order to lower its own costs.

The CCC submits that the NBNco should revert to the principle that it previously proposed of creating a PoI at the first point of competitive backhaul. Which routes were competitive would be determined by the Commission, not by NBNco, as it is properly the task of the regulator to make these determinations.

The Government could then decide the basis on which high cost regional routes (be they competitive or uncompetitive) were to be subsidised, and under what arrangements. The extent of any subsidy should be published on a route by route basis.

In the case of an uncompetitive route, this would mean that an RSP would acquire from NBNco an integrated last mile and backhaul service, but the price would be expressed in its component parts. That is, there would be a last mile access component price, a backhaul component cost, and a transmission/backhaul subsidy component. Such transparency of cost and price would also better assist the ACCC in regulating the NBNco within the framework of the expected Special Access Undertaking.

Potential entrants to the transmission/backhaul market that believe they could deliver the service at a lower price than the combined cost and subsidy components would be able to enter the market knowing that the price to NBNco from the present provider should not be able to be cut in response, as this would indicate to the ACCC that either its calculation of efficient cost was wrong or that the incumbent was engaged in predatory pricing.

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[i] This submission does represent the views of Primus Telecom