



**FINAL ACCESS DETERMINATION: THE
DOMESTIC TRANSMISSION CAPACITY
SERVICE
ACCC PRICING INQUIRY**

Reply Submission

PUBLIC VERSION

24 March 2016



This submission by Vodafone Hutchinson Australia (**VHA**) supplements its earlier submissions in the final access determination (**FAD**) inquiry for the Domestic Transmission Capacity Service (**DTCS**) and responds to the recent submissions made by Telstra (12 February 2016 - **Telstra Submission**) and Optus (February 2016 – **Optus Submission**).

VHA considers it necessary to respond to the Telstra Submission in particular because Telstra makes the mistake of viewing the benchmarking exercise as an end in itself rather than a means to help the ACCC make a FAD that promotes the LTIE. While the regression modelling that Economic Insights (**EI**) has undertaken may be a “statistical exercise”, the making of a FAD that promotes the LTIE is most certainly not. Rather, it is a decision of an experienced regulator with many tools at its disposal to review and assess the work undertaken by EI in light of the extensive and detailed submissions of stakeholders and the criteria in the *Competition and Consumer Act 2010* (**CCA**).

VHA considers it imperative that the FAD contain forward looking efficient prices for the DTCS. Inclusion of the eJV data and the adoption of a benchmarking model which employs some form of efficiency frontier will help meet that objective.

1 Use of eJV data

Telstra argues that the eJV data should not be included in the ACCC’s benchmarking data set (**Original Data Set**), because it is:

- part of a “closed arrangement” and not reflective of what would be expected in a competitive environment (Telstra Submission, p12); and
- substantially different from the “relatively harmonious” existing data set (Telstra Submission, pp12 and 13).

Both of these arguments are without merit for the reasons set out below.

The eJV data reflects a commercial deal

It is not entirely clear what Telstra means by a “closed arrangement”. However, as Optus rightly points out, it has largely been replaced by TPG as a provider of transmission services to VHA (Optus Submission, p 6), which strongly suggests that the eJV services are being provided on a genuinely competitive basis (unless Telstra contends that the TPG agreement is similarly “closed”). Otherwise, the decision to acquire services for TPG would be irrational.

The initial criteria for inclusion in the ACCC’s data set are satisfied

While it is true that the VHA/Optus deal comprises a number of elements, that is typical of most wholesale services agreements, including Telstra’s modular wholesale services agreements, which cover a range of services. Were arrangements of this kind to be excluded from the Original Data Set, it would likely result in many, if not all, of the existing Telstra data points being removed.

The initial data gathering exercise did not exclude observations on the basis that they formed part of a commercial arrangement covering a range of activities and it is impossible to know the extent to which those arrangements are reflected

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in the Original Data Set without requesting additional information from service providers.¹ There can be no justification for subjecting the eJV data to criteria for inclusion that have not been applied to the balance of the observations in the Original Data Set. Indeed, principles of regulatory consistency and predictability dictate that the eJV data be included for that reason alone.

Differences between the eJV data and the Original Data Set have been exaggerated by Telstra

Telstra's contentions that the Original Data Set was relatively harmonious before the inclusion of the eJV data and that the eJV data is somehow an outlier are equally problematic for the following reasons.

First, its contention that the Original Data Set (pre-eJV) was "relatively harmonious" in terms of the key drivers of price is simply not sustainable. Professor Bartels has previously detailed his concerns about the Original Data Set including evidence of extensive bundling practices stating that [REDACTED] and that this kind of bundling "severely handicaps any efforts to construct a regression model that aims to provide an explanation of how different drivers impact on prices".² So, while the eJV data reflects bundling arrangements, it is no more divorced from the discernible drivers of price in the Original Data Set than [REDACTED]

Secondly, on several occasions Professor Bartels commented upon the significant degree of unexplained volatility in the price data in the Original Data Set such that prices for services that are substantially the same varied significantly with the [REDACTED].³ This again suggests that, at least for portions of the Original Data Set, drivers of price remain relatively unexplained by available variables such as capacity and distance.

Thirdly, the impact of residual market power upon observations in the Original Data Set simply cannot be excluded and may go a significant way to explaining any differences between the eJV data and the balance of the observations in the Original Data Set (where Telstra is the largest supplier by a significant margin). EI has previously acknowledged the possibility of residual market power even on "exempt" routes.⁴ Professor Bartels has also identified a number of factors that point to residual market power on "exempt" routes. For example:

- [REDACTED]⁵ and
- to the extent that prices are bundled in the process of price formation, it is possible that market power exists across bundles of services, even when there are many providers on an individual route.⁶

¹ ACCC, *Public Inquiry to make a Final Access Determination for the Domestic Transmission Capacity Service - Further consultation paper*, December 2015, p3.

² Professor Robert Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [38].

³ Professor Robert Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [99]-[100].

⁴ EI, *Domestic Transmission Capacity Services Benchmarking Model – Draft Report*, 11 June 2015, at p 64.

⁵ Professor Robert Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [32].

⁶ Professor Robert Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [43].



Finally, excluding data on the basis that it displays certain “different” characteristics or because it produces “unreasonable” price outcomes (Telstra Submission pp 9-10), when it otherwise meets the criteria for inclusion is to reverse engineer the outcome of the benchmarking exercise – such an approach is clearly inappropriate and inconsistent with good regulatory practice.

2 Frontier approach is consistent with statutory objects

The ACCC’s statutory task is to promote the LTIE.⁷ As judicial consideration of these provisions makes clear, this prevents it from making determinations that enable an access provider to levy charges which are higher than those in a competitive market. A FAD must not enable an access provider to obtain monopoly rents, profit from inefficient investment or recover more than a reasonable proportion of the cost of any enhancements to its network.⁸

Telstra has consistently argued that the ACCC should adopt a model that benchmarks against average pricing across exempt routes (Telstra Submission, p 18). Telstra’s expert Professor Breusch has likewise opined that “*A benchmarking model is required to represent the overall or average relationship between the charge for a service on exempt routes and the observable characteristics of that service*”.⁹

However, Telstra’s approach would enable DTCS providers to obtain monopoly rents. This is because, as Professor Bartels has previously concluded:

“Professor Breusch makes the implicit assumption that the prices on exempt routes ... are efficient prices determined in competitive markets. The prices used for the benchmarking exercise exhibit characteristics that are plainly incompatible with competitive prices ... [an] indication that many of the prices used to estimate the benchmarking model are unlikely to be competitive is the extremely wide range of unexplained variation in prices. [REDACTED]

[REDACTED] *It would be hard to think of a truly competitive market with mostly large clients having such a wide range of prices for comparable products.*

This strongly suggests that the dataset used to estimate the benchmarking model is contaminated by non-competitive prices.”¹⁰

By contrast a SFA model of the kind estimated by EI in its most recent report¹¹ would substantially address this issue by focusing on lower, more efficient price observations.¹² Adoption of such a model, with any required adjustments, would clearly better promote the LTIE, or promote it to a greater extent, than the approach advocated by Telstra and its expert Professor Breusch.

⁷ The objects of Part XIC of the Competition and Consumer Act 2010 (section 152AB) and the FAD statutory criteria (section 152BCA).

⁸ *Telstra Corporation Ltd (No 3)* [2007] ACompT3 at [159]; and *Application by Vodafone Network Pty Ltd & Vodafone Australia Limited* [2007] ACompT 1 at [46], [49] and [68].

⁹ Professor Trevor Breusch, *Report on Economic Insights Final Report and 2015 DTCS Draft FAD*, 2 October 2015 at [2.1].

¹⁰ Professor Robert Bartels, letter dated 19 November 2015 lodged as an attachment to the VHA submission dated 2 December 2015, section 4.

¹¹ EI, *Domestic Transmission Capacity Services Benchmarking Model: Testing Further Specifications*, January 2016.

¹² This is a point that Professor Bartels has previously made in *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [60].



Given the overwhelming evidence that the data set to be used to estimate the benchmarking model is contaminated by inefficient prices,¹³ there is clearly no basis for seeking a 49% premium on SFA pricing to align prices with average prices as asserted by Telstra (Telstra Submission, p18). It is an obvious error to assume that historic (and now significantly out of date) prices should equate to efficient, forward looking future prices. VHA is confident that the ACCC is cognisant of this issue and will take it into consideration in making its final decision.

There may be some minor variations in efficient costs between providers (for example due to economies of scale) that warrant the application of a small premium. VHA accepts EI's stated position that there may not be any statistically precise method for doing this, however this should not prevent the ACCC exercising its regulatory discretion in setting a small premium (e.g., 5%) based on its extensive knowledge of the telecommunications industry. Indeed the ACCC has a statutory obligation to do so if it considers the adoption of a SFA model to be in the LTIE.

3 Provider dummy

If the ACCC decides to adopt a random effects rather than a SFA model VHA agrees with the submission of Optus that Telstra should not be set as the provider dummy (Optus Submission pp 21-22 see especially [7.5]).

VHA reiterates its previous submission that there are no strong grounds for choosing the median provider over the lowest cost provider at scale and, in selecting the more efficient provider, the ACCC could correct for any residual non-competitive effects.¹⁴

4 2Mbps services

VHA has previously indicated that it is not convinced that the benefits of adopting a different approach to regulating 2Mbps services would outweigh the likely detriments in terms of further delaying the finalisation of the DTCS FAD.¹⁵

This is particularly so given that the industry as a whole is moving towards higher capacity transmission links and 2Mbps services increasingly reflect older, less efficient technologies. However, like Optus, VHA sees no reason why the ACCC should not use existing commercial pricing as a price ceiling for 2Mbps services or indeed across the board. As a matter of principle, given the ACCC's statutory objective of promoting the LTIE by approximating competitive pricing, there can be no legitimate basis for determining pricing above that which has been commercially agreed.

¹³ This includes evidence that: the majority of exempt routes have only one provider (Professor Robert Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [32]); market power may exist across bundles of services, even when there are many providers on an individual route (Professor Robert Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015, at [43]); and prices of comparable services have an extremely wide range around their average (Professor Robert Bartels, letter dated 19 November 2015 lodged as an attachment to the VHA submission dated 2 December 2015, section 4).

¹⁴ VHA, *Final Access Determination: the Domestic Transmission Capacity Service – Submission in response to the ACCC's draft decision*, 9 October 2015, p4.

¹⁵ VHA, *Final Access Determination: the Domestic Transmission Capacity Service – ACCC Pricing Inquiry – Submission on the October expert reports of Professor Breusch and CEG*, 2 December 2015, section 1.



5 Decision must be an exercise in regulatory discretion

VHA is aware of the recent Australian Competition Tribunal decision setting aside the 2015 final decision of the Australian Energy Regulator on the allowed revenues for the electricity network businesses of Networks NSW (**ACT Decision**).¹⁶ While the circumstances of this inquiry can readily be distinguished, it is a timely reminder that a regulator should not solely rely upon the modelling undertaken by an expert it has retained. Rather, it must proactively exercise its regulatory discretion in a manner that promotes the LTIE.

There are clear limitations to the data before the ACCC, including its age and questions about whether the modes of price formation (even on exempt routes) uniformly reflect effective competition. These limitations have been addressed in a number of previous VHA Submissions and reports by Professor Bartels. Nevertheless, at this late stage in the process, the LTIE will be best promoted if the ACCC acknowledges them and proactively adopts a modelling approach that will mitigate their impact as far as possible within as short a timeframe as is reasonably possible.

In VHA's view this is likely to necessitate the adoption of dynamic pricing and/or a SFA approach. However, the critical element of any robust exercise of the ACCC's regulatory discretion will be that it gives meaningful consideration to each of the statutory criteria and assesses the impact of its FAD over the short, medium and longer term in light of those criteria.

In the absence of a detailed disclosure by Telstra of its cost data, the best any FAD can hope to do is approximate efficient costs of supply. The ACCC must therefore seek to promote the LTIE as best it can, based on the information it has before it. It goes without saying that the continuation of the status quo for any further significant period will not promote the LTIE.

6 Way forward

Ultimately the task of the ACCC is to determine efficient, forward looking pricing. Given the limitations of the data the ACCC has to work with (including its age) VHA submits that this will be best achieved by adopting:

- a SFA approach; and
- dynamic pricing which reflects the significant reductions in cost and increased efficiencies since the price observations in the ACCC's data set were agreed.

Even if the ACCC does not accept VHA's contentions, it must ultimately be satisfied that the approach it settles upon is the one will produce the most efficient, forwards looking regulated prices for the DTCS.

¹⁶ Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1.