

Hutchison Telecommunications (Australia) Limited

and

Hutchison 3G Australia Pty Limited

**SUBMISSION TO
THE AUSTRALIAN COMPETITION & CONSUMER COMMISSION
REGARDING
BUNDLING IN TELECOMMUNICATIONS MARKETS**

14 February 2003

1. Introduction

Hutchison Telecommunications (Australia) Limited and Hutchison 3G Australia Pty Limited (together **Hutchison**), welcome the opportunity to respond to the Commission's draft Information Paper entitled '*Bundling in Telecommunications Markets*' released 13 January 2003 (**the draft information paper**).

Telstra's retail pricing practices, specifically bundling and associated discounting, represent the most significant and pressing current threat to competition in Australian telecommunications markets. Hutchison believes the Commission needs to do the following:

1. issue a Part A competition notice;
2. conduct an urgent investigation into Telstra's retail pricing practices; and
3. support the introduction of an ex ante remedy requiring Telstra to seek the Commission's consent to a proposed bundled package before Telstra offers that package to the public.

Hutchison first raised the issue of bundling with the Commission over 12 months ago. If Telstra's retail pricing practices continue uninvestigated, even for a short period, there is a considerable risk that competition will be damaged irrevocably. There is little doubt that Hutchison's first mover advantage in relation to 3G services will be affected.

The need for an ex ante remedy is very clear and Hutchison emphasises that:

- in the telecommunications sector, a more aggressive approach has been adopted overseas to deal with bundling;
- reactive remedies have significant limitations, notwithstanding employment of imputation analyses; and
- bundling will foreclose markets to new entrants introducing new technology.

2. Executive Summary

- A common feature of Telstra's bundled packages is the requirement that the customer acquire local telephony services and basic access from Telstra. It is beyond question that Telstra has a substantial degree of power in a number of telecommunications markets by reason of its ownership of the only ubiquitous customer access network in Australia.
- Telstra's current retail pricing practices are in breach of sections 45, 46, 47 and 151AK of the *Trade Practices Act 1974 (TPA)*. The Commission should issue a section 155 notice if it does not yet believe it has sufficient evidence to issue a competition notice.
- Telstra's current and proposed bundling threatens competition at a crucial stage in the development of the telecommunications industry, namely, the introduction of 3G. For this reason, an ex ante remedy is required in addition to a full investigation by the Commission.

-
- Determining whether bundling is anti-competitive using imputation testing is a difficult and time consuming task and employment of imputation analysis has yielded inconclusive results overseas.
 - Bundling and related discounting, superficially appears to benefit consumers. It is not however, ultimately in consumers' interests as it:
 - reduces competition; and
 - prevents consumers from analysing the value of components of a retail bundle.

3. The draft information paper

Hutchison believes the draft information paper is a positive step towards dealing with telecommunications bundling, and agrees with the following principles expressed in it:

- bundling is only likely to be anti-competitive when the carrier concerned has market power in the supply of at least one of the bundled products;
- bundling is anti-competitive if it forecloses competition in a market by, for example, reducing a competitor's addressable market; and
- imputation analysis can be a useful tool in assessing vertical price squeeze and predatory pricing.

Hutchison raises five significant issues that are not dealt with in the draft information paper:

1. Remedies other than those provided in Part XIB of the TPA are needed to deal with bundling.
2. There will be circumstances in which bundling by Telstra has the potential to reduce a competitor's addressable market, which may not involve predatory pricing, vertical price squeeze or tying.¹
3. Competition in certain telecommunications markets is driven by niche operators such as Hutchison which provides mobile services only. Hutchison's concern is not whether Telstra engages in a vertical price squeeze but whether its retail pricing practices involve a 'margin squeeze'. To match Telstra on price, in relation to Telstra's Rewards package, Hutchison is forced to reduce its retail prices by substantially more than 10%, with obvious consequences for Hutchison's margin.
4. Imputation testing while a useful tool, is a complex and time consuming process that may prove inconclusive.
5. The Commission's report '*Regulatory Principles for the Public Disclosure of Record-Keeping Rule Information*',² appears to support public disclosure of the information (including cost data) used by the Commission to determine whether Telstra is engaging in

¹ The draft information paper alludes to this on page 14. It does not however, elaborate on the issue and the relevant paragraph is limited to possible 'one bill effects'.

² 24 January 2003.

a vertical price squeeze or predatory pricing. Hutchison submits that such information should, except in the most extraordinary circumstances, be available to the public.

While bundling may provide consumers with an immediate benefit (for example, a discount or the convenience of one bill), the Commission cannot consider those short term consumer benefits independently of their effect on competition. The courts have consistently stated that the operation of Part IV of the TPA is predicated on the assumption that competition is a means to serving consumer interests.³ This is also implicit in the object of Parts XIB and XIC of the TPA, namely, the long term interests of end users of listed carriage services.

This paper is structured as follows:

- **Section 4** sets out a brief history of bundling by Telstra and **section 5** describes the trade practices implications of that conduct.
- **Section 6** sets out some of the additional consequences of Telstra's conduct, particularly in relation to pricing transparency and margin squeeze.
- **Section 7** illustrates the limitations of imputation testing by reference to two UK case studies.
- **Section 8** sets out the likely impact of Telstra's bundling on Hutchison's ability to offer 3G services in Australia.
- **Section 9** deals with the public disclosure of information acquired under the RAF.
- **Section 10** sets out a proposed remedy to alleviate as far as possible the anti-competitive effects of bundling by Telstra.
- **Section 11** describes briefly some ex ante remedies that have been adopted overseas.

4. Telstra's retail pricing strategy

Telstra owns the only ubiquitous customer access network in Australia. In June 2001, Telstra had over 10 million access lines in service. By contrast, Optus was estimated to have around 450,000 local access lines in service.⁴ Telstra currently accounts for about 81% of local telephony revenue and 83% of retail local services.⁵

The markets for the supply of long distance and international calls are relatively contestable.

We set out below details of the development of Telstra's retail pricing strategy since March 2000 when it first commenced bundling.

³ *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Co Ltd* (1989) 167 CLR 177 per Mason CJ and Wilson J. This was recently reiterated by the High Court in *Boral Besser Masonry Limited (now Boral Masonry Ltd) v ACCC* [2003] HCA 5 (7 February 2003).

⁴ Telstra's submission to the ACCC in support of Telstra's notifications to resell FOXTEL subscription television services together with Telstra's telephony and other telecommunications services dated 15 July 2002.

⁵ *Telecommunications Competition Regulation*, Productivity Commission, 27 September 2001 at page 99.

Date	Product	Features	Comments
03/00	Homeline suite of products⁶	<p>Homeline Part: basic line rental and local calls.</p> <ul style="list-style-type: none"> • Line rental \$21.90 • Local call 22c • STD and F2M⁷ cap \$2.50⁸ (7pm to MN; 4pm to MN Saturday) <p>Homeline Complete: bundles line rental, local calls, long distance, international and fixed to mobile calls.</p> <ul style="list-style-type: none"> • Line rental \$21.90 • Local call 22c • Neighbourhood call 15c • STD and F2M cap \$2.50 (7pm to MN; 4pm to MN Saturday) <p>Homeline Plus: bundles line rental, local calls, long distance, international and fixed to mobile calls.</p> <ul style="list-style-type: none"> • Line rental \$24.90 • Local calls 18.5c • Neighbourhood calls 15c • STD and F2M cap \$1.50 (7pm to MN; 4pm to MN Saturday) 	<p>Under the ACCC's pricing principles for the local carriage service, the local call price is calculated by applying the retail minus methodology to Telstra's 'unbundled' local call offering. Therefore, the wholesale access price is arrived at with 22c as the starting point. This is notwithstanding that 25% of all Telstra local calls are neighbourhood calls,⁹ and are available as part of retail bundled offerings at 15c.</p>

⁶ While Homeline bundles have existed since 2000, the prices quoted are current from 1 August 2002.

⁷ Fixed to mobile.

⁸ The cap applies only when an override code is used.

⁹ Most Telstra calls which share the same exchange are classified as neighbourhood calls.

09/00	Rewards Program	<p>Telstra Rewards: builds on Homeline bundles by adding internet access and mobile telecomm services.</p> <ul style="list-style-type: none"> • 5% or 10% discount for customers across eligible charges¹⁰ on fixed and mobile services and internet services when these services are billed to the one bill. • discount increases from 5% to 10% if more services are bundled together. • 15% anniversary discount.¹¹ 	
09/00	Telstra Relationships	<p>Telstra Relationships: further discounts the bundle which includes line rental, local calls, long distance, international and fixed to mobile calls.</p> <ul style="list-style-type: none"> • 50% discount on calls between Telstra mobiles and fixed line services on one bill; or • 25% discount on calls between Telstra mobiles and fixed line services on one bill.¹² 	
11/02	Telstra Rewards – pay TV services	<p>Telstra Rewards with pay TV: expands the bundle of products offered in the Rewards package to include Pay TV services.</p> <ul style="list-style-type: none"> • 5% or 10% off eligible charges.¹³ • Discount increases from 5% to 10% if more services are bundled together. 	The anniversary discount continues to apply to those customers who took up the bundle prior to August 2002.

¹⁰ Eligible charges do not include: call costs under Homeline Plus, calls discounted under the Telstra Relationships offer and broadband internet charges.

¹¹ Customers joining the Rewards Program after 1 August 2002 are not eligible for this discount.

¹² The discount applied depends on the value of the mobile contract acquired.

¹³ Eligible charges do not include: call costs under Homeline Plus, calls discounted under the Telstra Relationships offer and broadband internet charges.

2003	Telstra Rewards – Broadband services	Telstra Rewards with broadband: Telstra intends to expand further the bundle of services discounted under the Rewards program, to include broadband internet services including ADSL.	ADSL is a relatively immature market. This conduct is clearly directed towards providing Telstra with a first mover advantage in this market.
------	---	--	---

Three points emerge from the above summary:

1. Telstra has progressively added more services to its initial bundled offering.
2. A fundamental feature of Telstra's bundled packages is the offer of a benefit, reward or discount to local call customers in connection with their acquiring additional services from Telstra.
3. To be eligible for Telstra's bundled package customers must acquire line rental and local calls from Telstra, the market in which Telstra enjoys overwhelming dominance.

In its revised final report regarding the pricing principles for the local carriage service dated April 2002, the ACCC stated:

*In its submission, Telstra claims that the loss of a local call customer will invariably result in the loss of that customer for all other telecommunications services as well.*¹⁴

Telstra's strategy is clear:

- ensure customers continue to receive local calls from Telstra thereby reducing significantly competitors' ability to supply other telecommunications services to those customers; and
- offer those customers an additional incentive, in the form of a discount, to ensure that they continue to acquire local call services from Telstra.

Telstra has stated that:

- *We found that customers are 2 to 3 times less likely to change carrier if they are taking a package and they are on one bill.*¹⁵
- *The bundling of telephone, internet and subscription TV services on a single customer-convenient bill will allow Telstra to discount prices and reward customer loyalty.*¹⁶

It is estimated that some 20% of all Telstra's fixed line customers are currently acquiring services under the Rewards offer.¹⁷ Attachment A sets out some extracts from investor analysts reports regarding Telstra's bundling.

¹⁴ At page 23

¹⁵ Ted Pretty, quoted by Anne Davies, "Bundling is Online Mantra for Telstra", Sydney Morning Herald, 5 December 2000.

¹⁶ Ziggy Switkowski, quoted by Bernard O'Riordan, "More choice and rewards for loyalty", Australian Financial Review, 8 March 2002.

¹⁷ CSFB First.Tel Global Telecom Daily, Credit Suisse First Boston, 23 August 2002.

5. Why Telstra's conduct is anti-competitive

In Hutchison's view, the Commission has sufficient information to believe that Telstra's conduct contravenes sections 45(2)(a)(ii) and (b)(ii), 46, 47, and 151AJ(2) and (3) of the TPA. Therefore, the Commission should issue a Part A competition notice. As a minimum, and in the alternative, it should exercise its information-gathering powers under section 155 of the TPA and conduct an urgent investigation into Telstra's retail pricing practices.

5.1 Sections 45, 46 and 47 of the TPA

Hutchison submits that by offering customers the Rewards package, Telstra is in breach of the TPA because:

- Telstra is giving effect to or has entered into a contract, arrangement or understanding which has the purpose or has or is likely to have the effect, of substantially lessening competition.
- Telstra has a substantial degree of power in a number of telecommunications markets, most relevantly the national retail market for local telephony services and is taking advantage of that power for the purpose of:
 - preventing the entry of Hutchison or other carriers, CSPs or ISPs in markets for new technologies such as 3G or broadband internet; or
 - deterring or preventing Hutchison or other carriers, CSPs or ISPs from engaging in competition in various markets for telecommunications services.
- Telstra is giving or allowing or offering to give or allow, a discount in relation to the supply or proposed supply of telecomm services by Telstra on condition that customers will not, or will not except to a limited extent, acquire telecom services directly or indirectly from Hutchison or other carriers, CSPs or ISPs.

The contract, arrangement or understanding: section 45

Telstra's contract with its local call customers constitutes a contract for the purposes of section 45. The relevant provision of that contract is that which offers customers (in the event they acquire long distance, international and fixed to mobile calls), a discount of 5% off eligible charges if they acquire an additional service (being either internet access, mobile services or pay TV services) or 10% if they acquire two additional services (the **bundle provision**).¹⁸

To determine whether the effect or likely effect of the bundle provision is to substantially lessen competition in a market, section 45(4) enables the court to take into account all other contracts to which Telstra is a party. The bundle provision appears in each Telstra contract with a local call customer. Telstra currently has a contract with over 80% of all fixed line customers in Australia and of those customers, it is estimated that some 20% (**or 16% of all residential customers in Australia**) have taken up the Rewards offer in some form.

¹⁸ See Telstra SFOA: "General Terms and Conditions" and "Telstra rewards packages section of the SFOA", annexed to this submission.

Telstra's market power and use of that power: section 46 and 151AJ(2)

To be eligible for Telstra's Rewards program, consumers must acquire local call services and line rental from Telstra. The relevant market in which to assess Telstra's market power for the purpose of section 46 is the national retail market for the supply of local telephony services. Telstra has a substantial degree of power in that market because:

1. Telstra currently accounts for around 81% of retail local telephony revenue and 83% of retail local services.¹⁹
2. Telstra owns the only ubiquitous customer access network in Australia.
3. There are significant barriers to entry in this market such as the sunk costs involved in rolling out a customer access network.
4. Competitors are dependent upon Telstra for the supply of access to the essential inputs necessary for them to supply services at the downstream level.
5. Telstra is vertically integrated and further, its competitors are ultimately dependent on Telstra for the supply of the essential inputs necessary for them to supply a competitive local call service (for example, the local carriage service, the PSTN originating and terminating access service or the ULLS).
6. Significant barriers to switching exist. During an investigation in the UK by the Director General of Telecommunications into certain pricing practices by BT, the Director General found that *there is some evidence that significant barriers to switching exist, which prevent customers changing suppliers to take advantage of competing offers.*²⁰

Hutchison cannot determine whether Telstra's bundled package (including relevant discounts) involves predatory pricing or a vertical price squeeze. Hutchison simply does not have access to any information obtained by the Commission pursuant to the regulatory accounting framework (see below). Notwithstanding this information asymmetry, Hutchison makes the following comments:

- the discounts in Telstra's Rewards program are not explicitly related to any cost savings;
- the only cost savings that are relevant are those relating to retail functions associated with the bundle; and
- if Telstra has not engaged in a vertical price squeeze, Hutchison believes it has still taken advantage of its market power for it would not have engaged in such conduct if it did not dominate the customer access network. Further, Telstra's market power clearly made it

¹⁹ *Telecommunications Competition Regulation*, Productivity Commission, 27 September 2001 at page 99.

²⁰ Investigation by the Director General of Telecommunications into the BT Surf Together and BT Talk & Surf Together Pricing Packages dated 4 May 2002 at page 11 (paragraph 49). The Director General went on to state that a *potentially enduring barrier to switching is provided by the perceived quality of service and reputation of alternative suppliers. Experimentation with alternatives is sometimes perceived as risky and this can give rise to switching costs where customers are not well informed about the service quality of rival operators. Survey evidence suggests that lack of awareness and information remain barriers for some customers.*

easier for Telstra to act for the proscribed purpose (see below) than would otherwise be the case.²¹

- Telstra's bundling conduct is directed towards substantially reducing competitors' ability to acquire customers in relation to the provision of a range of telecommunications services.
- Telstra has indicated that when it loses a local call customer it invariably loses that customer for the provision of all other telecommunications services.²² By parity of reasoning, if Telstra retains its local call customers it has substantially greater scope to retain that customer for all other telecommunications services. This could be attributed to the 'one bill effect', customer inertia or simply the fact that it is easier to sell a product to an existing customer than to a potential customer.

Exclusive dealing

Section 47(2) of the TPA prohibits Telstra from supplying services at a discount on condition that the purchaser does not acquire services from a competitor. The effect of the Telstra Rewards bundle is that customers cannot purchase telecommunications services from competitors because they do not have the capacity to use additional services: their requirements having been met by Telstra.²³

5.2 Purpose and effect: sections 45(2), 46, 47(2), 151AJ(2)(b)(i) and (ii) and 151AJ(3)(a)

The Telstra packages have been used by Telstra to 'tie' up customers and thereby substantially prevent competitors from competing with Telstra for the acquisition of their custom. In Hutchison's view, Telstra has engaged in such conduct for a purpose proscribed by section 46, namely, preventing a person from entering a market, or, deterring or preventing a person from engaging in competitive conduct in a market.

Telstra executives have stated on numerous occasions that by bundling services and offering various discounts, competitors have substantially less scope to compete. If this is the foreseeable commercial result, then Hutchison submits it must have been Telstra's substantial purpose in engaging in the conduct.²⁴

Hutchison submits that Telstra's conduct will have the effect or likely effect of substantially lessening competition in the mobile telephony market by foreclosing the market to niche players such as Hutchison.

Telstra itself recognises the foreclosing effect of its conduct. Dr Switkowski stated recently in a speech given at the CSFB conference in Hong Kong:

²¹ In *Queensland Wire*, Dawson J concluded that BHP's refusal to supply QWI with Y-bar was made possible only by the absence of competitive conditions. In *Melway*, the High Court stated that there is a possibility that, in a given case, it may be proper to conclude that a firm is taking advantage of market power where it does something that is materially facilitated by the existence of the power, even though it may not have been absolutely impossible without the power. The High Court went on to accept the ACCC's submission that section 46 would be contravened if the corporation's market power made it easier for the corporation to act for the proscribed purpose than would otherwise be the case.

²² Telstra's submission to the Commission in relation to local carriage service pricing dated 12 May 2000.

²³ *Cool and Sons Pty Ltd v O'Brien Glass Industries Ltd* (1981) 35 ALR 445.

²⁴ Section 46(7) enables relevant purpose to be inferred from relevant circumstances.

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 a 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.²⁵

The ACA in a recent report states that approximately 84% of all respondents in a survey conducted by the ACA indicated that they would prefer to obtain all their telecommunications services from the same provider.²⁶

When considering whether an agreement or conduct lessens competition, one applies the with or without test (that is, compare the state of competition with the conduct or agreement and without it).²⁷ Hutchison submits that the bundle provision has the effect of foreclosing customers for which Hutchison could otherwise compete and therefore the provisions have the likely effect of substantially lessening competition.

5.3 Further information

In Hutchison’s view it is imperative that the Commission exercise its information-gathering powers to gain a range of information regarding Telstra’s conduct. A suggested schedule to a section 155 notice is confidential attachment A.

6. Other anti-competitive consequences

6.1 Margin Squeeze

Consumers are likely to choose to include mobile services in their Telstra Rewards bundle, as they generally pay more for mobile services than internet access and pay TV services. For that reason, a 10% discount on mobile services offers customers a greater saving on their total bill, than a 10% discount on the other services.

Hutchison must offer customers a discount substantially greater than 10% in order to make it commercially attractive for the customer to forgo Telstra’s bundled package. The consequence for Hutchison’s margin is set out in confidential attachment B. The more services Telstra adds to the bundle, the greater the reduction in its competitors’ margins.

The effect therefore of Telstra’s conduct is to substantially lessen competition even where the competitor is efficient. The draft information paper does not adequately deal with this issue.

²⁵ 27 March 2001.

²⁶ Consumer Awareness and Information Needs Survey, October 2002.

²⁷ *Re Queensland Independent Wholesalers Ltd* (1995) 132 ALR 225.

6.2 Pricing Transparency

Telstra's Rewards program lacks pricing transparency. The Commission has previously been provided with a paper by Joshua Gans and Stephen King entitled 'Achieving Price Transparency in Bundles' dated 21 October 2002. The authors state in relation to Telstra's Rewards program:

If there is no bundling, then the posted price for say Telstra's mobile service is the price competitors know they have to beat in order to attract customers. Regulatory authorities can easily cross-check such prices against competition laws.

Telstra's bundling does not allow full price transparency to either competitors or regulatory authorities. From the perspective of competitors, they do not know the average price customers are actually paying for a Telstra service. In particular, competitors need to know what price the greatest proportion of Telstra mobile customers are paying to know what price to beat. However, without detailed information regarding Telstra's subscribers to fixed line, Pay TV and internet, it cannot easily assess this. In this respect, bundling makes pricing less transparent.²⁸

Again, the draft information paper does not deal with this issue.

7. Imputation analysis, while helpful is not the answer

7.1 Limitations of imputation testing

The imputation test is helpful in identifying anti-competitive conduct but has a number of limitations which Hutchison describes below.

1. Bundling conduct may be anti-competitive even where the conduct passes the imputation test.
2. The imputation test is complex and time consuming. To that extent, using the imputation test in a Part XIB investigation to determine whether current bundling conduct is anti-competitive, means that Telstra may continue to engage in the bundling conduct in the interim. If the bundling conduct is anti-competitive, the damage to competition will be irreversible.
3. The imputation test may not always conclusively establish whether the conduct is pro-competitive or anti-competitive. Both n/e/r/a and the Commission recognise this in their reports. n/e/r/a relevantly states:

The objective of tests for anti-competitive price squeezes is to establish a line between behaviour that is "aggressively competitive", which should be encouraged, and behaviour that is anti-competitive, which should be prohibited. However, establishing where this line falls is not straightforward and as is discussed in section 3, at best competition authorities end up with a blurred boundary rather than a crisp threshold. Even at a theoretical level, there is debate as to the appropriate way to determine where the line should be drawn and whether this should be on the basis

²⁸ At page 5

*of protecting **competitors** or on the basis of protecting a **competitive environment**.*²⁹

The draft information paper implicitly recognises this limitation, as it describes the procedure the Commission will follow to identify when bundling is likely to be anti-competitive. The Commission will:

- first conduct the imputation test on the basis of average total cost. While pricing below average total cost is not conclusive of anti-competitive conduct, it justifies further inquiry; and
- if Telstra is pricing above marginal costs, then the conduct falls within what the Commission has designated as a “grey area”.³⁰ The Commission will then proceed to consider other factors such as whether the pricing will have an appreciable effect on existing competitors or new or potential entrants to the market.³¹

The need to consider Telstra’s pricing strategy (and costs) in the context of current competition in the relevant markets, is supported by the High Court’s decision in *Boral Besser Masonry Ltd v ACCC*³² (*Boral*). This further inquiry will increase the time required to determine whether Telstra’s bundling conduct is anti-competitive. Again, if such conduct is in fact anti-competitive, the damage to competition that will occur until such time as the Commission concludes its investigation, will be irreversible.

4. There is scope for Telstra to ‘game’ the application of the imputation test. The comments of Gaudron, Gummow and Hayne JJ in *Boral* are instructive:

*It is as well at the outset to say that measuring costs is seldom free from difficulty. Dividing costs between the fixed and the variable can be a matter of arbitrary assignment. Identifying, quantifying and attributing costs incurred, often many years ago, in obtaining the plant and equipment used in a manufacturing process is beset with problems. Those problems are magnified and multiplied when the vendor whose costs are to be measured, such as BBM, is one entity in a vertically integrated corporate group. It follows that identifying the “cost” of goods manufactured by BBM required the making of many assumptions and decisions about which there could be different views.*³³

The Commission seems to suggest that the price of a bundled package is only anti-competitive if it involves Telstra engaging in a vertical price squeeze or predatory pricing. If this is the

²⁹ n/e/r/a, ‘Imputation Tests for Bundled Services’ January 2003 at page 7.

³⁰ At page 19.

³¹ At page 19.

³² *Besser Masonry Limited (now Boral Masonry Ltd) v Australian Competition & Consumer Commission* [2003] HCA 5 (7 February 2003).

³³ *Besser Masonry Limited (now Boral Masonry Ltd) v Australian Competition & Consumer Commission* [2003] HCA 5 (7 February 2003) at para 157.

Commission's position, then Hutchison disagrees with it. Gans and King³⁴ make the following points:

- the discount offered by Telstra under the Rewards Program is an ad valorem reduction in a customer's payments over all relevant services. Such 'total bundle' discounts can lead to individual products being priced below incremental cost;
- the incremental price, from the customer's perspective, is not the amount which the customer pays for a particular service. Rather, it is the additional amount it is billed in connection with its decision to acquire an additional service and thereby move from a 5% to a 10% discount. In most cases, this is an amount substantially less than the price for the service. Indeed, as Gans and Kind point out, there exists a possibility that in some cases, the incremental price is negative;
- this is best illustrated by way of example. Assume that the customer's bill comprises local call costs of \$20; long distance call costs of \$100; fixed to mobile call costs of \$30; and mobile call costs of \$60. The customer's total bill is \$210 and the customer receives a 5% discount (given that they are acquiring an additional service from Telstra). The saving is \$10.50 and the customer pays \$199.50. If the customer decides to also acquire pay TV services for \$20 as part of the bundle, the customer's total bill would be \$230, with a 10% discount of \$23. The customer pays \$207 in total. In other words, the customer is ultimately paying \$7.50 for pay television services; and
- the issue in these circumstances therefore, is whether the incremental price exceeds the incremental cost.

We refer to Telstra's supplementary submission to the Commission dated 17 October 2002 in relation to Telstra's pay TV notification. There, Telstra's representatives state:³⁵

*Imputation testing can have some value, but its importance should not be exaggerated. The Trade Practices Act 1974...for example, does not refer to imputation testing and imputation testing is certainly no substitute for the actual provisions of the Act. An imputation test, therefore, will not be determinative of whether or not particular conduct breaches the Act. Failing an imputation test does not mean that there is a taking advantage of market power in breach of section 46, or that there is an effect of substantially lessening competition. **On the other hand, a positive (or zero) result on an imputation test does not necessarily mean that the conduct in question is lawful** (emphasis added).*

7.2 Record Keeping Rules

It appears from the draft information paper and the Commission's report 'Regulatory Principles for the Public Disclosure of Record-Keeping Rule Information' that the Commission may publicly disclose the information on which it conducts any imputation test. Hutchison submits that the public disclosure of that information will, to some extent, overcome the limitations of imputation

³⁴ 'Achieving Price Transparency in Bundles' dated 21 October 2002.

³⁵ At paragraph 1.1.

testing described in section 7.1 above, and for that reason, *promote competition in markets for listed services* as well as *facilitate the operation of Part XIB*.³⁶ Other players in the industry are well placed to evaluate the cost data used by Telstra as well as the assumptions relied on including cost drivers and cost allocation methods. This will to some extent, reduce the scope for Telstra to 'game' the application of the imputation test and further, assist the Commission to verify the 'results' of its analysis. The disclosure of that information (particularly cost data) will not adversely affect Telstra's legitimate commercial interests.³⁷

7.3 Some overseas experience with imputation testing

There have been two recent cases in the UK in which the Office of Fair Trading employed imputation analysis to assist it determine whether breaches of the Competition Act³⁸ had occurred. These cases demonstrate that the process is time consuming and not necessarily conclusive.

(a) BSkyB investigation

The first investigation involved BSkyB, a vertically integrated company which competes at all functional market levels in the UK, TV industry. BSkyB owns rights, produces programmes and channels, distributes its channels to wholesalers and also packages channels and supplies at retail.³⁹

The OFT commenced its investigation in December 2000. In December 2001,⁴⁰ the OFT announced that it proposed to make a decision that BSkyB had breached the Competition Act by:

- setting a retail price for its subscribers which was not sufficiently above the wholesale price charged to other distributors to allow a third party distributor to make a normal profit (that is, a vertical price squeeze);
- offering discounts to distributors who take a package of goods, at a level such that rival channel providers were prevented from entering the market; and
- offering discounts on products at a level which may prevent rival channel providers from entering the market.

In December 2002⁴¹ the OFT announced its final decision, namely that all of the analysis returned a borderline result as BSkyB failed the imputation test for some of the period examined but passed for the remainder. Therefore, after lengthy inquiry, OFT concluded that evidence independent of imputation testing was needed before a finding of breach could be made. Relevantly, the conduct continued unabated during a substantial part of the investigation.

³⁶ Section 151BUA of the *Trade Practices Act 1974*.

³⁷ Section 151BUA(4) of the *Trade Practices Act 1974*.

³⁸ *Competition Act 1998* (UK)

³⁹ *BSkyB: The outcome of the OFT's Competition Act investigation*, OFT, December 2002 at page 3.

⁴⁰ *PN 51/01 OFT proposes to find BSkyB in breach of law*, OFT, 17 December 1999.

The test used by the OFT to detect a margin squeeze (vertical price squeeze) was:

...whether BSkyB had set its wholesale prices at a level that would prevent a distributor earning a normal return on the distribution of BSkyB's premium channels, even if it was as efficient as BSkyB.⁴²

This test is similar to the Commission's proposed imputation test. The OFT found that the application of this test required: extensive economic and financial analysis; making a number of assumptions 'as reasonably as possible'; and assessing costs of services.

(b) BT investigation

The second investigation involved BT. It had offered a product whereby a consumer wishing to access the internet using a dial up modem was required to purchase 2 main access products:

- internet service provision (a link to the internet) which is supplied by an ISP; and
- access calls connecting the customer to the ISP which is provided by a telco.

These products are sometimes sold together and sometimes sold separately. This investigation dealt with the supply by BT of unmetered off-peak access calls which consumers used to connect to ISPs.

On 2 November 2000, BT notified the Director General of Telecommunications (the **Director**) of two new price tariffs for packages that it wished to commence selling on 1 December 2000. The packages relevant to the investigations were "BT Surf Together" and the "BT Talk & Surf Together" which cost £14.99 and £19.99 respectively. Those packages provided off-peak unmetered internet access calls as well as cheap voice calls. The more expensive package also included off-peak unmetered voice calls.

The Surf component of the packages is a BT product which provides off-peak unmetered access calls for connecting a customer to their ISP. The Surf⁴³ component can be purchased separately as the product SurfTime for off-peak unmetered calls to ISPs at £5.99.⁴⁴

BT also offered the voice call only portions of the packages as the products BT Together and BT Talk together at £11.99 and £14.99 respectively.

The Director commenced an investigation in November 2000 into the pricing of the packages offered by BT. It was suspected that the packages may distort competition in the markets for retail internet access and wholesale termination of internet calls through horizontal leveraging, vertical leveraging or both. Specifically, the Director was concerned that:

⁴¹ *PN 89/02 OFT concludes BSkyB investigation*, OFT, 17 December 2002.

⁴² *BSkyB: The outcome of the OFT's Competition Act investigation*, OFT, December 2002 at page 6.

⁴³ Surf is offered only from DLEs (Digital Local Exchanges) which 'groom' internet traffic from the PSTN and reroute the call over a more efficient IP network to the ISP.

⁴⁴ SurfTime Anytime can be used to purchase unmetered internet access calls 24 hours a day, 7 days a week for £19.99, however the investigation was not concerned with this product as it was not included in the packages.

-
- the Surf element in the bundle would be offered below marginal cost resulting in **horizontal leveraging** from BT's apparent dominance in the markets for local and long distance retail voice calls on fixed networks into internet access markets; and
 - a **margin squeeze** could be implemented by reason of BT's dominance in the wholesale fixed network call origination market being vertically leveraged into internet access markets.

The imputation test applied by OFTEL was:

whether an equally efficient competitor (incurring the same relevant costs as BT) could at least match BT's price for Surf

Interestingly, during the course of the investigation, BT announced certain reductions in its interconnection prices. This had the consequences of reducing the wholesale costs and assisting BT in relation to the imputation test. Ultimately, OFTEL found, some 5 months later, that the results of the imputation testing were inconclusive. The conduct continued through the investigation. This demonstrates that while imputation analysis may be a useful analytical tool it should be used prospectively to assess proposed bundling.

8. Appropriate ex ante remedy

8.1 The need for an ex ante remedy

Hutchison believes that given the potentially significant anti-competitive consequences of bundling, an ex ante remedy is essential.

The remedies available in Part XIB are insufficient in this context:

- Part XIB investigations are time consuming. Imputation testing, while useful, does not minimise the time taken to determine whether bundling conduct is anti-competitive. The two UK case studies described above illustrate the time involved in conducting the imputation analysis.
- There are evidential difficulties in determining when bundling by Telstra is anti-competitive. Some of those difficulties are:
 - The recent High Court decision in *Boral* illustrates the difficulty in establishing when a retail pricing strategy contravenes section 46 of the TPA. An implication of the decision appears to be that evidence of purpose may be relevant to establishing whether the corporation has taken advantage of market power. *If the impugned conduct has a business rationale, that is a factor pointing against any finding that conduct constitutes a taking advantage of market power.*⁴⁵ This may broaden the

⁴⁵ Per Justice Heerey at first instance referred to in *Besser Masonry Limited (now Boral Masonry Ltd) v Australian Competition & Consumer Commission* [2003] HCA 5 (7 February 2003) at para 170.

inquiry the Commission is required to undertake before making a decision as to whether the conduct has contravened the competition rule which was intended to focus on the “effect of the conduct”. If the conduct is anti-competitive, the damage to competition that will occur in the interim will be irreversible.

- The time taken by the Commission to issue a competition notice has been protracted by recent amendments to the TPA which require the Commission to provide the recipient with the opportunity to make submissions before a Part A competition notice can be issued.
- To the extent the conduct can continue unabated for a substantial period of time, the damage to competition will be irreversible.

Hutchison proposes a regime which requires Telstra to first inform the Commission of its proposal to bundle telecommunications services. Telstra could then only bundle once the Commission had consented to the proposal on the grounds that it was satisfied that the conduct would promote competition in a market for listed carriage services.

An ex ante remedy addresses the concerns referred to above in relation to Part XIB. Further, it places the onus on Telstra, the person best placed to establish the purpose or likely effect of the conduct. This does not impose a substantial burden on Telstra, as the UK case study involving BSKyB illustrates. There, BSKyB convinced the OFT that the conduct did not breach the Competition Act, even though the OFT had previously issued a draft report that it did.

The use of an ex ante remedy is supported by the position overseas, particularly in Hong Kong and the UK (see below). Further, a recent report for the European Commission examined the implications of the convergence of fixed and mobile networks for the regulatory framework in the European Union. Many of its findings are highly relevant to Telstra’s current and proposed bundling of pay TV services with fixed and mobile services. The findings also highlight the manner in which Telstra’s bundling can adversely affect competition in the mobile retail market. The report noted:

*...the integration of fixed and mobile services will bring greater potential for the bundling of services and the subsequent lack of transparency in commercial dealings, which may require the introduction of a **series of structural competitive ex ante obligations in order for anti-competitive practices to be capable of detection, or even to be prevented from occurring.***

...Given the privileged market position of fixed incumbent operators, there is a question of whether they are under an obligation of prior disclosure to competitors before they introduce fixed/mobile integrated packages and pricing schemes for such packages.

...As a result of the possible future convergence of mobile and fixed terminal equipment which may act as a “gateway” for Internet and other content-rich applications, it is arguable

*that competition law remedies may be required to ensure the openness of such gateways.*⁴⁶ (emphasis added)

8.2 Retail price control

Hutchison believes that the most appropriate manner in which to implement such a regime is:

- The Minister should make a retail price control arrangement of the kind described above under Part 9 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999* (Cth) (the **T(CP&SS) Act**). This can be an interim measure.
- In due course, the TPA should be amended to incorporate the retail price control arrangement.

If the Government is not minded to amend the TPA, the retail price control arrangement would apply in order to provide an appropriate and effective framework for implementing an ex ante remedy. There are 3 reasons why this is an appropriate remedy. Further, the process by which Telstra's conduct is assessed could include the use of imputation analysis as foreshadowed by the Commission.

1. The retail price control regime has been used effectively in the past to require Telstra to notify the Commission and obtain its approval before varying call charges. As the Commission is aware, under Part 9 of the T(CP&SS) Act, the Minister has the power to make a determination that specified carrier charges are subject to **price control arrangements**. While the concept of *price control arrangement* is not defined in the T(CP&SS) Act, the Act expressly envisages that price control arrangements extend to arrangements other than price-caps (section 155(3)) including controls which require Telstra to obtain the Commission's consent for alteration to call charges.⁴⁷
2. A retail price control of the kind sought in this submission is consistent with the object of Part XIB of the TPA which is directed towards ensuring that the Commission is in a position to deal **expeditiously** with anti-competitive conduct in the industry and to **minimise** the anti-competitive effect of such conduct. To that end, while Part XIB contains a mechanism by which the Commission can issue a competition notice, it also contains provisions requiring Telstra to notify the Commission of Telstra's intention to impose new charges.⁴⁸ Similarly, the Commission may issue a tariff filing direction to Telstra (given its substantial degree of market power in many telecommunications markets) requiring Telstra to provide

⁴⁶ Analysis, Study for EC DG Information Society, *Consumer Demand for Telecomm Services and the Implications of the Convergence of Fixed and Mobile Networks for the Regulatory Framework for a Liberalised EU Market*, January 2000, pages 95-96.

⁴⁷ Ministerial determinations: *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2002*; *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2001*; *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2000*; *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 1999*.

⁴⁸ Division 5 of Part XIB.

the Commission with certain information before it imposes a new charge, varies a charge or ceases to impose a charge for specified goods or services.⁴⁹

The retail price control sought by Hutchison is consistent with that objective, namely, providing the Commission with prior notice of Telstra's decision to offer a bundle of services. It also builds upon those regimes in Part XIB by ensuring that Telstra does not bundle until such time as the Commission determines that the conduct will promote competition.

3. The retail price control sought by Hutchison is consistent with the object and purpose of the T(CP&SS) Act which is to:

- promote the long term interests of end-users (including the promotion of competition in a market for listed carriage services); and
- promote efficiency and international competitiveness of the Australian telecommunications industry.⁵⁰

A price control arrangement dealing with bundling which has anti-competitive consequences is consistent with the objects of the *Telecommunications Act 1997*. The arrangement is directed towards promoting competition generally and therefore the long-term interests of consumers.

8.3 Proposed Ministerial Determination

Hutchison proposes the following content for a Ministerial Determination:

No Packages are to be supplied without prior consent from the Commission.

Telstra must first notify the Commission and obtain its consent before offering a Package.

The Commission may only consent to Telstra offering a Package if the Commission is satisfied that the Package will promote competition in a telecommunications market.

Package

A Package is a product which comprises the following features:

- (a) *a service is supplied in connection with at least one other service; and*
- (b) *a feature of the supply is:*
 - (i) *a charge (including a nil charge) for one of the services in the package is lower than that offered to customers who acquire that service other than as part of the package; or*
 - (ii) *the offer of a discount, rebate, credit, allowance or other technical feature (such as greater bandwidth) is only available to customers acquiring the package; or*

⁴⁹ Division 4 of Part XIB.

⁵⁰ Section 9 of the T(CP&SS) Act and section 3 of the *Telecommunications Act 1997*.

- (iii) *the overall price for the package is lower than the amount customers would pay if they were to acquire the services other than as part of the package.*

Matters to which the Commission must have regard

Without limiting the matters the Commission must have regard to in determining whether a Package promotes competition in a telecommunications market, the Commission must have regard to the following factors:

- *the current state of competition in the market for the Package and/or any other relevant market including the markets in which the services which are offered as part of the Package are supplied;*
- *the services that are offered as part of a Package including whether Telstra is offering a service in which it has a substantial degree of market power in the market for that service with another service or other services in which it does not have the same degree of market power;*
- *whether another person supplies a service which is offered as part of the Package or is able to do so in competition with Telstra;*
- *any effect offering the Package may have on competitors;*
- *the commercial viability of a competitor offering the same price or a discount of the same magnitude as Telstra in connection with the provision of a service which is offered as part of the Package;*
- *the possibility that offering the Package may foreclose a market.*

8.4 Relationship with third line forcing notification

Telstra has undertaken to provide the Commission with:

- 30 days' notice prior to increasing the discount on its current Rewards package; and
- 14 days' notice under the notification provisions in section 93 in respect of any third line forcing conduct.

Prior notification by Telstra of proposed bundling conduct is not a substitute for the ex ante remedy proposed. There needs to exist a mechanism for the Commission to assess proposed bundling by Telstra before the bundle is available at retail. To the extent the conduct is anti-competitive, the consequences are likely to be irreversible.

For these reasons, Hutchison also submits that tariff filing directions are not useful remedies.

9. International comparisons

9.1 Introduction

Ex ante remedies have been employed in other jurisdictions, where proposed discounts by dominant telcos are scrutinised **before** those discounts are implemented. We consider below two examples of existing ex ante remedies similar to that proposed by Hutchison.

9.2 Hong Kong

The Hong Kong regulatory regime recognises that discounting by a dominant telco may have a deleterious effect on competition. The regulatory framework provides that a dominant telco must obtain prior approval of a tariff **before** it is changed and may **not discount** from that tariff unless the discount has first been approved.

(a) Licence conditions

Telecommunications specific competition regulation in Hong Kong is addressed mainly through licences issued under the *Telecommunications Ordinance Cap 106 (Telecomms Ord)*. The Telecomms Ord specifies that telecommunications services can only be operated in accordance with a licence issued by the Telecommunications Authority (*Telecomms Authority*) under that Ordinance. Section 8 of the Telecomms Ord makes it an offence to operate a telecommunications service without a licence or in breach of conditions specified in that licence.

(b) Price controls on dominant telcos

- Section 7F(3) of the Telecomms Ord is an anti-bundling provision prohibiting combining a number of telecommunications services into a single tariff without offering the services separately at individual tariffs.
- General conditions imposed on licences require **dominant carriers** to:
 - publish a tariff and obtain the Telecomms Authority's approval of that tariff before it can commence pricing in accordance with the tariff (General Conditions 21 and 22);⁵¹
 - not charge above a published tariff (General Condition 20(1)); and
 - not offer a discount to the published tariff (other than a discount calculated in accordance with a formula or methodology which has been approved by the Telecomms Authority) (General Condition 20(4)).

(c) Enforcement

The Telecomms Authority may issue a notice requiring a licensee to pay a financial penalty for non-compliance with: a licence condition; a provision of the Telecomms Ord or

⁵¹ The Telecomms Authority shall not approve the tariff if the proposed charge would lead to a contravention of prohibitions on anti-competitive conduct, abuse of position or the "no-discounting" rule.

Regulation; or any direction made by an authority. Fines imposed by notice range from HK\$200,000 to HK\$1,000,000 depending on whether the breach has occurred before. Alternatively, the Telecomms Authority may apply to the Court for penalties of up to 10 per cent of a licensee's turnover in a market or HK\$10,000,000. Other penalties which can be imposed by notice to a licensee include corrective advertising or disclosing certain information relating to the breach to specified persons.

A person can bring an action for damages, an injunction or other appropriate remedy if they have sustained loss or damage arising from a breach of a licence condition relating to a competition provision.

9.3 United Kingdom

The regulatory framework in the United Kingdom requires that pricing by dominant telcos must be transparent and their proposed discounting schemes require scrutiny before they are implemented.

(a) Licence conditions

Telecommunications operators must carry on their business under licenses issued pursuant to the *Telecommunications Act 1984* (UK). Telecommunications licenses issued in the United Kingdom contain standard conditions, however, those conditions do not need to be complied with unless the Director General of Telecommunications has made a determination to that effect.⁵²

(b) Transparency and scrutiny of pricing by dominant telcos

- General Condition 7 requires all licensees who operate a public telephone service to make available to the public its standard terms and conditions.
- Operators of fixed public telephone services with significant market power must:
 - observe a period of public notice before implementing a tariff change (Condition 54);
 - ensure discount schemes are **fully transparent**; and
 - ensure discount schemes do not show **undue preference** to, or exercise **undue discrimination** against particular persons or classes of persons.
- The Director may direct a licensee to modify or withdraw a discount scheme (Condition 54).
- Similar conditions apply to dominant telcos offering services other than fixed public telephone services.

⁵² *BT's regulatory obligations to provide advance notification of price changes and to maintain a published price list*, OFTEL, 28 June 2001.

10. Additional Legislative Reform

In the light of recent High Court decisions regarding section 46,⁵³ Hutchison believes that the competition rule in section 151AJ should be amended to remove the 'taking advantage' element.

Specifically, section 151AJ(2)(b)(i) should be amended by replacing the words 'takes advantage of that power' with the words 'engages in conduct'. Section 151AJ(2)(b)(ii) should be amended by deleting the words 'takes advantage of that power' and the word 'other'.

Hutchison believes that this reflects the underlying purpose of the competition rule and will not adversely affect Telstra's ability to compete. It must still be shown that Telstra's conduct has the requisite effect, namely, damaging the competitive process rather than a competitor. Telstra can still engage in conduct 'to meet competition'.

11. Conclusion

Hutchison first raised the issue of bundling with the Commission over 12 months ago. The practice must now be thoroughly investigated. While issues such as the most useful formulation of the imputation test are not unimportant, in Hutchison's view they may serve to distract the Commission from the immediate task of addressing the conduct principally with the introduction of an ex ante remedy. Delay, as always, favours Telstra.

⁵³ *Melway Publishing Pty Limited v Robert Hicks Pty Ltd t/as Autofashions Australia* (2001) 205 CLR and *Besser Masonry Limited (now Boral Masonry Ltd) v Australian Competition & Consumer Commission* [2003] HCA 5 (7 February 2003).

Attachment A

Analysts Views of Telstra's Bundling

15 June 2001 – ABN AMRO

As the incumbent with greatest market share Telstra has potentially the most to lose from MNP, particularly in the lucrative business market segment of which Telstra has a disproportionately large share (around 75%). However, Telstra has the benefit of being able to offer bundled services (fixed, mobile and internet) which promotes customer loyalty. Telstra has very low churn rates compared to its competitors (only 1.4% per month compared with competitors at 2-3%).

Bundling of services is a competitive advantage for Telstra that it is only just beginning to fully exploit. At the recent management briefing Telstra has indicated that about 10% of its retail customers now are on some form of bundled package and that net churn rates for its fixed line business are running virtually zero.

15 June 2001 – ABN AMRO

Telstra dominates the business market and other operators believe that this is in part because of the reluctance of business customers to change numbers. Both Optus and Vodafone see MNP as a key opportunity to attack the business customer base of Telstra. Telstra believes that it has a key strategic advantage in its ability to offer a bundle of services to increase the stickiness of its mobile product something that it is getting better at doing in more recent times.

25 September 01 – Deutsche Bank

During late 2000, Telstra launched aggressive bundling campaigns aimed at reducing market share losses and churn by playing to Telstra's ability to bill across multiple products, including mobile, internet, long distance and local calls.

In addition to single bills, Telstra also launched products that deliver fixed rate calls across long distance calling zones, discounts for calls between linked Telstra mobiles and home phones and more recently capped calls between home phones and Telstra mobiles. Home users must be Telstra retail customers to take advantage of these offers. These products are extremely difficult for competitors to match.

23 August 2002 – CSFB First.Tel

We estimate between 15% and 20% of Telstra's consumer customers are currently on a bundled package, but current bundles do not include pay TV.

15 July 2002 – Macquarie Research Equities

The most significant implication is that Telstra's management information systems appear insufficient to calculate margins for bundled and segmented services. It is therefore difficult for Telstra to demonstrate that overall margin improvement is due to underlying economic gains rather than an anti-competitive exploitation of its incumbent position.

