Australian
Competition &
Consumer
Commission

BUNDLING
IN
TELECOMMUNICATIONS MARKETS

An ACCC *Information paper*

August 2003

Important notice

Please note that this information paper is a summary designed to give you basic information on the Commission's approach to assessing potentially anti-competitive bundling behaviour in telecommunications markets. This information paper does not cover the whole of the Trade Practices Act and is not a substitute for professional advice.

Moreover, because this information paper avoids legal language wherever possible there may be some generalisations about the application of the Act. Some of the provisions referred to have exceptions or important qualifications. In most cases the particular circumstances of the conduct need to be taken into account when determining the application of the Act to the conduct.

1 Introduction

Bundling of one type or another has been a feature of the telecommunications industry for some time. Recently, there has been a significant increase in the number and range of bundled packages being supplied by carriers or carriage service providers (CSPs). Coinciding with the growth of bundled packages, there have been increasing concerns from both industry participants and consumers in regard to issues of transparency and possible anti-competitive conduct arising from such practices.

The purpose of this information paper is to provide carriers, CSPs, and other industry stakeholders (including end-users) with the approach the Australian Competition and Consumer Commission (the Commission) is likely to follow when assessing whether specific bundling conduct in the telecommunications industry is anti-competitive. The approach details key factors the Commission will consider when determining whether a carrier or CSP has engaged, or is engaging in, anti-competitive conduct. In this regard, this information paper can be considered supplementary to the Commission's existing information paper titled 'Anti-competitive conduct in the telecommunications markets'.[1]

This information paper also discusses the Commission's information gathering powers, with specific reference to bundling conduct. These powers enable the Commission to monitor market behaviour within the telecommunications industry, and can inform the Commission of, and allow it to investigate and evaluate, potential anti-competitive behaviour.

Two reports prepared by National Economic Research Associates (NERA) for the Commission[2] were provided with the draft version of this information paper.[3] These reports were used by the Commission to prepare the draft information paper and have also assisted the Commission with the preparation of this final report.

This report is structured as follows:

Chapter 2 provides background on bundling, discusses its wide use in the telecommunications industry, and also details its potential benefits and detriments.

Chapter 3 provides background on relevant enforcement and information gathering powers of the Commission under the *Trade Practices Act 1974* (the Act).

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1 Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets — Information Paper*, 1999. In particular, an extension of the discussion on bundling found on p. 26.

2 Refer NERA, *Imputation Tests for bundled services — A report prepared for the Australian Competition and Consumer Commission, Sydney,* January 2003*,* and NERA, *Anticompetitive bundling strategies — A report for the Australian Competition and Consumer Commission*, Sydney, January 2003.

3 Australian Competition and Consumer Commission, *Bundling in telecommunications markets — an ACCC draft information paper*, January 2003.

In Chapter 4, the Commission provides guidance on how it will assess whether particular bundling conduct is anti-competitive. In particular, this chapter focuses on the assessment of barriers to entry and possible vertical price squeezes.

In Chapter 5, issues surrounding the further use of information gathering powers to monitor and investigate the conduct detailed in chapter 4 are discussed.

2 Background

2.1 What is bundling?

Bundling generally refers to the situation where two or more products or services are sold as a single package.[4] The price of the bundled package is usually at a discount to that of acquiring given amounts of the products separately, and a residential consumer is likely to receive only one bill for all of the services provided in the bundle.[5]

There are various selling strategies for bundling in telecommunications markets. One strategy consists of the products being available either individually or in a package. For example, Telstra's mobile telephony services are available on an unbundled basis and also on a bundled basis with (at least) fixed telephony services.

Another strategy refers to the situation where a product is sold only on a bundled basis. In telecommunications, line rental and local calls generally are not sold as individual services but are only provided together in a bundled package.

A further strategy involves the supply of one service (the tying product) conditional on one or more other services (the tied products) also being supplied. This is commonly referred to as tying. In this case the tying product is only available on a bundled basis. For example, pay TV content 'tiers', such as movie channel packages, can only be obtained from Foxtel or Optus if at least the basic content package is also acquired.

Bundling can include the services of only one company (a 'full line' force), or the services of different companies (a 'third line' force). The Act has specific provisions concerning third line forcing, which is a *per se* contravention.

Bundling may also involve both telecommunications and non-telecommunications services. Its use may also create new product markets. This may be relevant to issues of market definition, and to the assessment of competition issues.[6]

2.2 Current bundling in the industry

Bundling is becoming a growing and important aspect of telecommunications service provision for carriers and CSPs. Retail bundling strategies are usually aimed at

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4 Most products can be considered a bundle of inputs, depending on the level of specificity. In this paper, the primary focus is on bundling between well-established product categories within telecommunications and related markets, such as national long-distance calls and dial-up internet services.

5 Services may also be discounted via 'introductory' or 'special' offers or through waiving otherwise payable charges such as installation or set-up costs.

6 See Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets — Information Paper*, 1999, pp. 26-27.

specific customer classes — corporate, small to medium enterprises or residential customers. For each customer class, carriers and CSPs appear to have a variety of bundled packages.

Examples of bundled packages offered in 2003 for residential customers of the two major carriers, Telstra and Optus, are outlined in Table 1.

Table 1 Examples of bundled packages offered to residential customers by Telstra and Optus in 2003

Telstra	Optus
'Telstra Rewards Packages': ▪ Fixed telephony and mobile; ▪ Fixed telephony and internet; ▪ Fixed telephony and pay TV; or ▪ Fixed telephony plus two or more of: – mobile; – internet*; or – pay TV.	▪ 'Choices 1' — Fixed telephony and pay TV ▪ 'Choices 2' — Fixed telephony and dial-up internet; ▪ 'Choices 3' — Fixed telephony, pay TV and dial-up internet; ▪ 'Choices 4' — Fixed telephony and high speed internet; or ▪ 'Choices 5' — Fixed telephony, pay TV and high speed internet.

Smaller carriers and CSPs also offer an array of bundled packages, although the number of services offered in the bundle is not always as extensive as those available from Telstra and Optus. For example, Primus offers a discount for a bundle comprising line rental, long distance calls, international calls, and internet access when obtained on a single bill.

For retail residential customers, Telstra and Optus cite bundling of services as a major competitive retail growth strategy. For example, Dr Switkowski, Telstra's Chief Executive Officer, said in 2001 that:

> Last September, we introduced "true" bundled product offerings to the residential market, where customers receive discounts when they group together their fixed, mobile and internet services. The early results are very pleasing, with nearly half of 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.[7]

Similarly, Optus reported that its bundling strategy has been very successful, with 81 per cent of new customers to its Consumer and Multimedia division, which offers

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[7] Ziggy Switkowski, Speech to Salomon Smith Barney conference, January 2001. Speech available as a company announcement to the Australian Stock Exchange, 11 January 2001 at <www.asx.com.au>.

local telephony, pay TV and high speed internet services over hybrid-fibre coaxial cable, taking more than one product.[8]

2.3 The potential benefits and detriments of bundling

Bundling may have associated benefits or detriments, depending on the specifics of the conduct. These specifics include the extent of market power held by the carrier or CSP providing the bundled services, the types of services being offered in the bundle, the structure of the markets for these services and any price discounts that are offered.[9] While there may be benefits associated with bundling, in some instances, there may be long-term detriment if competition decreases.

Bundling can be beneficial for both consumers and the carrier or CSP supplying the bundled services if it results in significant efficiencies and pro-competitive benefits. Bundling can allow carriers or CSPs to exploit economies of scope between bundled goods, and economies of scale if the bundling conduct has significant impacts on consumer demand. Consumers can gain when these benefits are passed on in the form of lower retail prices or quality improvements.

Benefits may also arise where bundling enables carriers or CSPs to discriminate between the price of services when they are supplied as a part of a bundle and when they are supplied individually. This allows carriers and CSPs to set prices such that profits are maximised and efficiency increased. Price discrimination can be defined as the practice of charging different prices to different consumers, for the same goods, where the price differences do not reflect differences in the cost of supply. Carriers or CSPs can also price discriminate via other means, such as different pricing for different geographical areas, and discounts for 'consumer loyalty'.

Consumers can also benefit from bundling by being able to receive one bill for many different services, although the extent of this benefit depends on their individual preferences. Benefits may further exist in terms of lower transaction costs.

Bundling can be detrimental for consumers and competitors of the carrier or CSP supplying the bundled services if it is used for anti-competitive purposes or has anti-competitive effects. Bundling may be anti-competitive if it forecloses or reduces competition by enabling the leveraging of market power from one market to another. In this way bundling may be used strategically to diminish competition or significantly reduce the ability of competitors in a particular market to efficiently compete. The pricing of a bundle of services may also raise anti-competitive conduct concerns, particularly if it is predatory or results in a vertical price squeeze. The potential for bundling to be anti-competitive is further discussed in section 4.

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8 Optus, *Annual Report to Shareholders 2001 – Part 2*, p. 24.

9 Services may also be discounted via 'introductory' or 'special' offers or through waiving otherwise payable charges such as installation or set-up costs.

3 Legislative Background

This chapter discusses the current provisions in the Act relevant to bundling conduct. This includes provisions relating to anti-competitive conduct and information gathering powers.

3.1 Enforcement under the Trade Practices Act

Currently, assessment of the effects of bundling can be considered under a number of provisions of the Act. The various provisions have different criteria to evaluate whether the conduct in question constitutes a breach of the Act. In assessing conduct under the anti-competitive conduct provisions, the behaviour may be subject to a test of substantially lessening competition, or a purpose-based test. Otherwise anti-competitive conduct may also be exempted from legal proceedings by the process of an authorisation or notification, which is usually subject to a public-interest based test.

3.1.1 Anti-competitive conduct provisions

The Act sets out anti-competitive conduct provisions relevant to telecommunications in Parts IV and XIB.

Part IV

Section 45 of the Act prohibits contracts, arrangements or understandings that restrict dealings or affect competition. For example, sub-paragraph 45(2)(a)(ii) states that a corporation shall not make a contract or arrangement, or arrive at an understanding, if a provision of the proposed contract, arrangement or understanding has the purpose, or would have or be likely to have the effect, of substantially lessening competition.

Section 46 proscribes misuse of market power by corporations that have a substantial degree of power in a market. This section prohibits taking advantage of that power for the purpose of eliminating or substantially damaging a competitor, preventing the entry of a person into any market, or deterring or preventing a person from engaging in competitive conduct in any market. Conduct which contravenes or is likely to contravene section 46 can not be authorised.

Section 47 of the Act prohibits exclusive dealing. Broadly, exclusive dealing involves one firm which trades with another imposing restrictions on the other's freedom to choose with whom, or in what it deals. For example, sub-sections 47(2) and (3) prohibit 'full line forcing', which involves the supply of goods or services on condition that the purchaser does not acquire goods or services from a competitor of the supplier. This conduct must have the purpose, effect or likely effect of substantially lessening competition before a breach of the Act will be made out. 'Third line forcing' conduct is not subject to a competition test, and is discussed in section 3.1.3 of this paper.

Part XIB

Section 151AK states that a carrier or CSP must not engage in anti-competitive conduct ('the competition rule'). Under section 151AJ a carrier engages in anti-competitive conduct if it:

- has a substantial degree of market power in a telecommunications market and it takes advantage of that power with the effect or likely effect of substantially lessening competition in that or any other telecommunications market; or

- engages in conduct in contravention of specified sections of Part IV of the Act, including section 45, 46 or 47, and that conduct relates to a telecommunications market.

In assessing bundling practices under the provisions in Part IV or Part XIB that are subject to a competition test, the Commission's approach would involve assessment of the likely impact on competition in the relevant market(s), guided by considering competition with or without the conduct. This assessment would not explicitly refer to any efficiency criteria, such as the impact on overall welfare (via analysis of consumer and producer surplus).

3.1.2 Authorisation/ notifications/ exemption orders

Under section 88 of the Act the Commission may, upon application, grant an authorisation to a corporation to enter and/or give effect to contracts, arrangements or understandings that fall under section 45, even if they are anti-competitive, so long as the Commission determines there are public benefits outweighing the anti-competitive detriment. While the authorisation remains, the corporation is granted immunity from legal proceedings for conduct that would otherwise breach the Act.

Similarly, section 93 allows a corporation to lodge a notification seeking immunity from the Act for conduct that falls under section 47. Protection can be withdrawn by the Commission if it determines that the conduct is likely to have the effect of substantially lessening competition and that no public benefit is likely to result, or the public benefit is not outweighed by the public detriment constituted by any lessening of competition.

Under section 151AS a carrier may seek an exemption for conduct of the type outlined in section 151AJ. The Commission must not make such an exemption order unless it is satisfied that the conduct will, or is likely to, result in a benefit to the public, and that benefit outweighs the detriment constituted by any lessening of competition. In determining whether these conditions are satisfied, the Commission may have regard to the criteria set out in section 151BC such as, but not limited to, whether the conduct relates to supply to community or charitable organisations.

Whilst the Act does not define what constitutes a public benefit, the Commission and the Australian Competition Tribunal have recognised that, among others, fostering efficiency and the promotion of competition in the industry are public benefits.

3.1.3 Third line force

Sub-sections 47(6) and (7) of the Act prohibit 'third line forcing', which involves the supply of goods or services on condition that the purchaser acquire goods or services from a particular third party or a refusal to supply because the purchaser will not agree to that condition.[10] This conduct is a *per se* breach, meaning that the conduct is illegal irrespective of its impact on competition.

Such arrangements may be protected from challenge through the authorisation process or by notification. Under section 93, a corporation may lodge a notification obtaining immunity from legal proceedings under the Act. Protection can be withdrawn by the Commission if it determines that the public benefit of the conduct is not outweighed by the public detriment.

3.2 Information gathering powers

The Commission has specific information gathering powers relevant to performing its functions or exercising its powers under Parts XIB and XIC of the Act (in addition to its general powers to obtain information under section 155). These powers allow the Commission to examine the pricing conduct of carriers and CSPs where there are concerns about anti-competitive conduct, or for use in determining appropriate access prices for declared services.

These powers also enable the Commission to monitor market behaviour within the telecommunications industry, allowing it to develop appropriate regulatory responses. In this regard, these powers are relevant in the context of monitoring of bundling conduct, which can inform the Commission of, and allow it to investigate and evaluate, potential anti-competitive behaviour.

3.2.1 Tariff filing

The Commission's tariff filing powers can be divided into two distinct parts:

- general telecommunications tariff filing; and
- Telstra-specific tariff filing.

The Commission has general telecommunications tariff filing powers under Division 4 of Part XIB. This allows the Commission to direct a carrier or CSP, with a substantial degree of power in a telecommunications market, to provide it with certain information on charges for specified carriage services and/or ancillary goods or

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[10] The Act distinguishes between conduct known as 'third line' and 'full line' forcing. In particular the Act prohibits a corporation from forcing consumers to obtain the product of another company (even a related company), or offering a discount on that basis (a 'third line force'). However, if the same practice was to occur within the one corporate entity, the practice would be considered 'full line forcing' and would be subject to a competition test under sub-section 47(2). The conduct would be lawful if it would not result in an adverse effect on competition.

services (including goods or services for use in connection with a carriage service) or information on its intentions regarding those goods or services.

The effect of a tariff filing direction is that the carrier or CSP must give the Commission details of its charges for goods or services covered by the direction. The carrier or CSP must also give the Commission details at least seven days in advance of imposing new charges, varying or ceasing to impose those charges for goods or services covered by the direction.

Division 5 of Part XIB requires Telstra to file information for all basic carriage services (BCS) with the Commission. Specifically, Telstra is required to provide the Commission with a written statement setting out its proposed pricing changes for each BCS. Telstra is required to provide this information at least seven days before imposing, varying or ceasing to impose a charge for a BCS.[11]

3.2.2 Record-keeping rules

Section 151BU of Part XIB empowers the Commission to make record-keeping rules (RKRs) by written instrument and require that carriers and CSPs comply with these rules. The rules may specify what records are kept, how reports are prepared and when these reports are provided to the Commission.

The Commission cannot require the keeping of records unless they contain information relevant to the responsibilities of the Commission. For the purposes of section 151BU, these responsibilities include the operation of Parts XIB and XIC.

Sections 151BUA, BUB and BUC provide for the Commission to disclose RKR information to the public or to specific persons under certain conditions.

Section 151BUAA of the Act enables the Minister to direct the Commission to exercise its RKR powers in a particular way, and to prepare and publish analysis of a Ministerially-directed report. Access to Ministerially-directed reports may be provided pursuant to sections 151BUDA-C.

3.2.3 Section 155

The Commission's primary mandatory power to obtain information in relation to enforcement functions is section 155. This enables the Commission to:

- obtain information or documents, or require the answering of questions under a formal examination where is has reason to believe that the relevant information relates to a contravention or possible contravention of the Act, or

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[11] A strict interpretation of Division 5 would require Telstra to provide complete details of all offerings, both standard and individualised (non-standard), along with variations made to these offerings. As this was viewed as administratively burdensome, the Commission and Telstra agreed to a streamlined tariff filing process that met the fundamental objectives of Division 5. This is detailed in *ACCC Telecommunications Reports 2000-01*, 4 March 2002, p. 30.

is relevant to a 'designated telecommunications matter' (which includes the performance of a function under Part XIB or XIC); and

- enter a person's premises to examine documents to ascertain whether the person has engaged or is engaging in conduct that may contravene the Act.

It is an offence under the Act for a person to fail to comply with a section 155 notice, even if providing information under the notice may incriminate that person for proceedings under the Act (where the person is a body corporate).

4 Bundling and anti-competitive conduct

As noted in section 2.3, bundling can be efficiency enhancing and pro-competitive, or anti-competitive depending on the specifics of the conduct. Section 3.1 outlined the provisions of the Act that proscribe anti-competitive conduct, which may be relevant when considering particular bundling conduct. This chapter provides guidance on how the Commission will assess particular bundling conduct, either in terms of the anti-competitive provisions in Part IV and XIB of the Act or as a part of public interest authorisation/notification considerations.[12]

It is important to note that the Commission will assess bundling conduct on a case-by-case basis, taking into account the specifics of the bundled package being assessed.

While the Commission will assess bundling conduct on a case-by-case basis there are two key elements which will form a part of the Commission's anti-competitive conduct or authorisation/notification/exemption considerations. These are:

- whether the non-price effects of the conduct are anti-competitive, such as involving the leveraging of market power from non-competitive to competitive markets, or whether the conduct increases barriers to entry; and

- whether the price(s) for the bundled services involves any elements of predatory pricing or a vertical price squeeze in the relevant market(s).

The Commission will consider these concerns individually and collectively.

In both cases, bundling conduct is only likely to raise anti-competitive conduct concerns when the carrier or CSP has market power in the supply of at least one of the bundled products.[13]

4.1 Assessing the non-price effects of the conduct

When a carrier or CSP bundles services and has substantial market power in at least one of the markets for those services, the Commission will inquire into whether the effect or likely effect of the non-price conduct is anti-competitive.

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12 This chapter only considers the competitive implications of the conduct and does not address all elements of a provision that need to be established for breach of the Act, or all relevant matters that may be taken into account when considering such conduct under the authorisation, notification or exemption provisions. In this regard, this chapter only forms one part of the Commission's overall consideration of specific conduct.

13 The Commission has commented on market power in telecommunications markets in Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets — Information Paper*, August 1999, at pp. 36-39.

For example, competition may be lessened if the carrier has market power and:

- sets prices at levels such that the pricing strongly encourages a significant proportion of consumers to purchase the bundle of services rather than individual services from competing carriers and CSPs;
- only supplies the services for which it has substantial market power within the bundled package, thus 'capturing' sales of the other services in the bundle for which it faces competition;[14] or
- the conduct has the effect of increasing barriers to entry or expansion.

The first point relates to pricing and may be able to be assessed through the predatory pricing and imputation tests outlined in the following section.

The second point refers to tying. For this strategy to be feasible, the carrier must have sufficient market power in the provision of the tying product to be able to coerce customers into purchasing the bundle.[15] The Commission is likely to consider the extent and nature of competition in markets for the tied and tying products when considering whether bundling conduct is anti-competitive.

The third point relates to barriers to entry and expansion. The Commission would have regard to the current magnitude and nature of these barriers (including both structural and behavioural barriers) and consider any changes to the barriers to entry and expansion as a result of the bundling conduct.

In assessing whether the conduct is anti-competitive, the Commission may consider *inter alia*:

- the state or likely state of competition in the various markets for the services in the bundle (including whether the services supplied in relevant markets are new or emerging);
- the likely future take-up of the bundled services;
- non-price terms and conditions of the bundle, such as the length of any contract;
- whether competitors face large one-bill effects[16] that would lead to a significant proportion of consumers only acquiring their services from one carrier. The assessment of one-bill effects will include the ability of competitors to offer like bundles and their ability to offer, at a reasonable price, the same suite of services;

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14 NERA, *Anticompetitive bundling strategies — a report for the Australian Competition and Consumer Commission*, Sydney, January 2003, p. 1.

15 ibid, p. 11.

16 This occurs where consumers value the convenience of acquiring all services from one carrier or CSP.

- the relationships between the goods or services provided in the bundle, such as whether they are complementary or a combination of wholesale and retail products, which can magnify any anti-competitive effect; and

- whether the segment of the market which is likely to purchase the bundle has particular characteristics (such as a high telecommunications spend) that will magnify or reduce the impacts on competition.

It is noted that these effects may be more pronounced in the event that competing carriers and CSPs are not able to supply some services within the bundled package.

4.2 Assessing pricing effects of the conduct

The Commission discusses anti-competitive pricing in the *Anti-competitive conduct in telecommunications markets* information paper.[17] In that paper, the Commission notes the pricing conduct that could have the effect of substantially lessening competition including predatory pricing and price squeezes.

This chapter supplements the discussion in that information paper, with particular focus on testing the price of bundled services. In particular, it outlines predatory pricing and vertical price squeezes for single services, and then discusses the assessment of such conduct when services are supplied as a part of a bundled package.

4.2.1 Predatory pricing and vertical price squeezes

Predatory pricing describes situations where a carrier or CSP with substantial market power sets prices below a particular measure of cost which results in it sacrificing short-term profits. Such conduct may, for example, have the purpose or effect of substantially lessening competition, or may result in equally-efficient competitors being forced to exit the market, and/or deter future competitive entry.

In contrast, while a vertical price squeeze requires that an integrated carrier possess market power, it is not necessarily the case that losses are incurred. An integrated carrier can achieve a price squeeze by reducing the margin between the retail price it charges in the downstream market and the wholesale access price it charges for an essential input to the downstream service, such that an equally-efficient competitor using that input will not be viable. The margin could be reduced by lowering the retail price for a service and/or raising the wholesale access price for an essential input.[18]

The supply of bundled services often involves discounted retail prices (as compared to when services are supplied individually). In this context, both predatory pricing and vertical price squeezes may be of concern — predatory pricing for carriers who have

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[17] See Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets – Information Paper*, August 1999, pp. 43-48.

[18] It is noted that even though margins may be reduced, carriers could still make profits if access prices were above costs.

their own wholesale access inputs and vertical price squeezes for carriers or CSPs reselling wholesale access inputs.

The question in both cases is whether bundling results in conduct which is anti-competitive. Predatory pricing and imputation tests can assist in making this assessment, although it is noted that these tests, in and of themselves, are not conclusive that conduct is anti-competitive. Rather they will be important diagnostic tools for assisting in determining whether conduct contravenes the Act.

4.2.2 Testing for predatory pricing and vertical price squeezes

Predatory pricing involves a carrier or CSP pricing its product or service below a particular measure of cost such that it sacrifices short-term profits. The test involves consideration of the full cost to the carrier or CSP of supplying the product or service. The cost basis for assessment of such conduct is discussed in section 4.2.3.

An imputation test can be used to assess whether or not an integrated carrier is engaging in a price squeeze. Unlike a predatory pricing test, which looks at the total cost of supply, an imputation test takes account of the wholesale access price an integrated carrier or CSP *charges* for the essential input that it supplies to its downstream competitors. An imputation test is designed to determine whether the margin between the price for a wholesale input and the retail price of a downstream service is sufficient to cover the retail costs of the integrated carrier.[19]

Imputation tests can be conducted on individual services or services supplied as part of a bundle. Where assessing the pricing of an individual service, the Commission will undertake imputation testing following the approach outlined in section 4.2.3 below. Importantly, it is likely to undertake an imputation test with reference to the market in which the conduct is occurring.[20]

However, complications can arise when applying imputation tests to bundled packages, particularly where market definition does not coincide with a bundled package. In this instance, the application of 'aggregate' imputation tests, which sum the relevant price and cost information for all services in the bundled package, may not be straightforward. The reasons for these complications include:

- the market of concern may be narrower than the bundle;
- the market of concern may include bundled and unbundled supply of services; and

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[19] There is an increasing amount of literature on the topic of imputation tests and its application to telecommunications industries. Refer S. King and R. Maddock, 'Imputation Rules and a Vertical Price Squeeze', *Australian Business Law Review*, vol. 30, no. 1, 2002, pp. 43-60 or submissions by Core Research, on behalf of AAPT or Hutchison in relation to Telstra's third line force notification. Copies of these latter reports are available from <www.accc.gov.au>.

[20] The Commission approach has been informed by advice sought from NERA on the appropriate way in which to test for anti-competitive price squeezes in telecommunications markets using imputation tests. Refer NERA, Imputation tests for bundled services.

- allowance needs to be made for circumstances where competitors can not supply all services in a bundled package.

In relation to the first point, that is where the market of concern is narrower than the bundled package, the Commission may remove the (price or cost) information relating to the non-relevant services(s). This means that information relating to the provision of only the service or services in the relevant market is tested.

Secondly, in instances where it is considered that the market includes bundled and unbundled supply of services, the Commission may weight the price and cost information to reflect the proportion of bundled and unbundled supply in the relevant market(s).

Finally, where competitors can not supply all services in a bundled package the Commission may impute the retail price of these services when supplied on an unbundled basis (if observable). This reflects that consumers will have the choice between the integrated carrier or CSP's bundle or the competitor's services and separate purchase of those services competitors cannot supply.

In undertaking any imputation test, it may also be necessary for the Commission to take into account economies of scope and scale relating to bundled service provision which can be readily incorporated into an 'aggregate' imputation test.[21]

4.2.3 Price and cost basis for assessing conduct

An important issue in assessing predatory pricing or price squeezes is whether the test is undertaken on a marginal cost or average total cost basis. As the names suggest, the marginal cost approach considers pricing and costs at the margin to determine whether a price squeeze or predatory pricing is occurring (or has occurred). An average total cost approach considers average prices and costs in making the assessment.[22]

The distinction between the marginal and average total cost based imputation tests can be summarised as follows:

- failing a marginal cost based test means the pricing practices are likely to be anti-competitive; and

- failing an average total cost based test is a necessary condition for establishing that pricing practices are anti-competitive but it is not, on its own, sufficient.[23]

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21 These economies may already be reflected in the financial reports, and no adjustment would then be required.

22 Under both the average total and marginal cost approaches, common costs may need to be allocated. As a starting point, the Commission may use the allocation rules set out in the Telecommunications Industry Regulatory Accounting Framework.

23 Refer NERA, Imputation tests for bundled services, p. 3.

The Commission notes that if a predatory pricing or imputation test based on average total costs is passed, a marginal cost approach would also generally be passed. In essence, a marginal cost approach generally sets a higher threshold for establishing that pricing conduct is likely to be anti-competitive than an average total cost test.

In the context of telecommunications services (including bundled packages), the Commission considers that an average total cost basis is likely to be an appropriate starting point for its price analysis.[24] This partly reflects the Commission's view that, in industries such as telecommunications, marginal costs are likely to be low and in some cases close to zero.

Further, low marginal costs also means that even where marginal revenues exceed marginal costs, operation at a price below average variable cost means the firm is not even covering its variable costs — which would be inconsistent with what would normally be observed in a competitive market. In this regard, conducting a test on a marginal cost basis would not necessarily be indicative of whether an equally-efficient provider would be able to remain in the relevant market(s) in the long-run. To eliminate this possibility the Commission believes that the marginal cost approach should be qualified to apply only where marginal cost exceeds average variable cost.

Having said that, pricing below average total cost is not necessarily indicative of predatory pricing or a price squeeze. Rather, the conduct may be consistent with competitive market behaviour where prices continue to make contributions above the average variable cost of supplying the service. This allows the carrier or CSP to recover some of the fixed costs associated with supplying the service. For example, if an entrant builds substantial additional capacity to supply a market, an initial period of intense competition and below average total cost pricing may follow as the entrant and the incumbent carriers or CSPs strive to utilise their available capacity. The price-cutting will likely cease when the growth in demand for the product or service catches up with the increase in total capacity. In this case, short-term pricing below average total cost is a reflection of intense competition in a product market characterised by economies of scale.

In light of this, the Commission considers a 'grey area' occurs where pricing conduct fails a predatory pricing or imputation test based on average total costs, but passes based on marginal costs (above average variable costs).

In the event that the conduct does fall inside the 'grey area', the Commission is likely to consider other factors to assist it in determining whether the conduct is anti-

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[24] NERA recommended to the Commission that marginal revenue and cost based tests are more definitive (compared to average total cost based test) as to whether pricing practices are likely to anti-competitive. NERA noted, however, that in practice the revenues and costs being considered would be for the volume of sales the firm would enjoy as a result of the conduct rather than the last unit sold. Therefore, the broader the market definition or longer the time period of the conduct, the higher the proportion of total revenues and costs that would be considered marginal. That is, the marginal cost based test would approach the analysis of an average total based test. In this regard, the viewpoint of the Commission is not necessarily inconsistent with NERA's conclusions.

competitive. Some issues relating to pricing which may be relevant to this consideration are listed below.

- Are there any regulatory or commercial reasons that the firm is pricing in such a manner? What is the intent of the firm in pricing in such a way?
- Will the pricing have an appreciable effect on existing competitors or new or potential entrants to the market?
- Are the retail price decreases of some substance and duration?
- Are the retail price decreases selective in terms of customers?
- Do past patterns of pricing conduct point to similar levels of pricing? For example, is seasonal pricing or pricing related to the utilisation of infrastructure capacity involved?
- What will be the likely future impact of the bundling conduct on retail prices for the relevant products or services?[25]

The Commission may also have regard to non-price elements in considering pricing conduct that falls in the grey area. These factors were outlined in section 4.1.

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[25] This effectively raises the issue of whether the carrier or CSP will be able to raise the retail prices for the goods to levels above the competitive level. The High Court noted in the recent *Boral* case that the likely ability of a firm to recover losses incurred through predatory pricing conduct is not essential to a finding of pricing behaviour in contravention of section 46, but it may be of factual importance. In particular, that recoupment may be useful evidence of market power. Refer *Boral Besser Masonry Limited (now Boral Masonry Limited) v Australian Competition and Consumer Commission* [2003] HCA 5, 7 February 2003, per Gleeson CJ and Callinan J at 130.

5 Information gathering and bundling conduct

In making assessments of potential anti-competitive behaviour or to inform its decisions in relation to authorisation or notifications, the Commission needs access to the right types of information to inform its decision making.

Different types of information are required for different elements of the Commission's consideration. The timing of the provision of information is also relevant.

- Tariff filing information allows the Commission to be informed of changes to the terms and conditions of supply of specified goods or services on an ongoing basis. This information is provided at least seven days in advance of any such changes, making the Commission aware of imminent product charges.

- The Commission's information gathering powers under section 155 may also be relevant in determining whether specific bundling conduct substantially lessens competition in a market or markets.

- Record-keeping rules are a flexible power that enables the Commission to receive information to assist it with:

  - assessing competition in a market or markets;

  - determining access prices for declared services, or undertaking predatory pricing or imputation test analysis; and/or

  - monitoring compliance by a carrier or CSP with a provision of the Act, such as compliance with the standard access obligations for declared services.

As noted, RKRs are a flexible power which allow the Commission to request various types of information for different purposes. In this regard, it is likely to be the most appropriate power for the ongoing collection of specific information from carriers or CSPs. This will also allow the Commission to have readily available information that may potentially be relevant to the consideration of whether particular bundling conduct is anti-competitive.

The following section outlines the Commission's current use of the RKR power. It also discusses the potential public disclosure of RKR information.

5.1 Regulatory Accounting Framework

The Commission already receives comprehensive information on costs, revenues and usage from Telstra, Optus, Vodafone, AAPT and Primus under the Telecommunications Industry Regulatory Accounting Framework (RAF) RKR. This RKR requires these carriers to provide financial information to the Commission on a regular basis, allowing the Commission to compare the (historical) unit cost of various services and provide increased transparency to assist in conducting imputation or predatory pricing tests. The RAF data may form the basis for such a test (although

additional information may be required to properly undertake the test), or it may assist in providing a 'sanity check' of a predatory pricing or imputation test using different data.

Additionally on 19 June 2003 the Minister for Communications, Information Technology and the Arts issued a 'special Telstra Direction' to the Commission under section 151BUAAA of the Act. This Direction required the Commission to issue RKRs to Telstra that extend the accounting separation regime under the RAF, including a requirement that some RAF information be released publicly.

Importantly, the special Telstra Direction included a requirement that the Commission prepares and publishes an imputation analysis (based on Telstra purchasing the 'core' interconnect services at the price that it charges external access seekers), to determine whether there is any systemic price squeeze behaviour. Pursuant to the Ministerial Direction, the Commission issued RKRs to Telstra on 26 June 2003.

5.2 Other Record-keeping rules

Notwithstanding the special Telstra Direction and the existing RAF information, the Commission was concerned that it had insufficient information to monitor bundling conduct in telecommunications markets. The Commission issued an RKR to Telstra to obtain further information from Telstra in regards to its residential bundling conduct.

The Commission requested that Telstra provide the following information:

- the total number of customers obtaining each type of bundled offering;
- the total number of new customers obtaining each bundled offering; and
- whether a discount is offered, and if so, the total accrued discount for each bundled offering.

The information allows the Commission to observe the impact that Telstra's existing bundles have on competition. This includes the impact which the bundling of pay TV with telephony services is having on relevant markets. The Commission could also use this information to assist it in any specific investigation of bundling conduct.

At this stage, the Commission only requires Telstra to provide it with this information. However, the Commission may extend the RKR to other carriers or CSPs where it believes that additional information may assist it in carrying out its functions.

5.3 Potential public disclosure of information

Under the Act, information in record-keeping rules can be disclosed in one of two ways — pursuant to the exercise of the Commission's discretion under sections 151BUA, 151BUB and 151BUC of the Act or pursuant to a Ministerial direction (for which the Commission must comply).

Under sections 151BUA-C of the Act, the Commission has the power to require public disclosure of RKR information where it assists in promoting competition and/or in facilitating the operations of Parts XIB and XIC through enhanced transparency and the benefits of doing so outweigh confidentiality concerns. These objectives may be achieved where RKR information assists carriers or CSPs to identify potential anti-competitive behaviour and thus enable these interested parties to initiate their own action under the Act, or by assisting the Commission in undertaking its functions and responsibilities under the Act.

As noted above, the special Telstra Direction requires the public release of imputation tests on Telstra's 'core' access services. The Commission would also consider public release of other RKR information whether it meets the requirements of the Act. The Commission released a report outlining its approach to the public disclosure of RKR information in January 2003.[26]

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[26] Australian Competition and Consumer Commission, *Regulatory Principles for public disclosure of Record Keeping Rule information — an ACCC report*, January 2003.