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By email

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Inquiry into varying the exemption provisions in the final access determinations for the WLR, LCS and PSTN OA services

Dear Kevin,

Macquarie Telecom Pty Limited ("**Macquarie**") appreciates the opportunity to make this submission to the Australian Competition and Consumer Commission ("**ACCC**") in relation to the ACCC's issues paper concerning the above.[1] The ACCC has already made final access determinations in respect of fixed line services ("**Fixed FADs**"). The Fixed FADs incorporate the effect of geographic exemptions which had been previously made by the ACCC and the Australian Competition Tribunal. The purpose of the ACCC's current inquiry is to decide whether the exemption provisions should be removed by way of variation to the Fixed FADs.

It is evident that Australia's communications sector is undergoing fundamental structural reform with the implementation of the national broadband network ("**NBN**"). This has involved the recognition at the policy level that the pursuit of facilities based competition in customer access markets has been ineffective and that the regulated monopoly supply of access services is now the preferred alternative. In this context, Macquarie is of the view that the geographic exemptions are a leftover of the pre-NBN environment and have no place in the transition to the NBN.

Macquarie is strongly of the view that competition for fixed line services (or resale services) is not effective in any geographic area let alone in the exempt geographic areas. It is evident that:

- Telstra is the dominant supplier of resale services in all markets relevant to this inquiry;
- there is a market for voice-only services which is distinct from a market for bundles of voice and broadband services;
- there is effectively no competition at the wholesale level for voice-only services and only limited competition for broadband and bundled services; and

[1] ACCC, Inquiry into varying the exemption provisions in the final access determinations for the WLR, LCS and PSTN OA services, Issues Paper, September 2011, ("**Issues Paper**")

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- there is no realistic prospect of new sources of resale services emerging which would have any material impact on Telstra's market power in the supply of resale services.

In the transition to the NBN environment, it is becoming evident that Telstra has begun to arrest the decline in the number of fixed line services it supplies which it has experienced in recent years.[2] This is no accident or unexpected occurrence. Rather it is a deliberate strategy of Telstra to retain its fixed line customer base with a view to migrating these customers to the NBN and at the same time weakening the position of competing retail service providers ("**RSPs**").

Telstra is currently able to charge (and access seekers have no practical choice but to pay) in excess of $31 per month for the WLR service in exempt geographic areas compared to the ACCC determined efficient price of $22.84 per month in non-exempt areas. This perverse situation demonstrates how ineffective competition is in the supply of resale services and how Telstra is aggressively retaining its fixed line customers. Macquarie submits that the exemption provisions purely serve Telstra's interests to the detriment of competition and the LTIE. Accordingly, Macquarie is of the very strong view that the exemption provisions as embodied in the Fixed FADs should be removed by way of variation.

Macquarie's responses to each of the questions raised in the Issues Paper are given below. For ease of reference, the consultation question is reproduced in *italics* which is then followed by Macquarie's response. The numbering of the questions follows that of the Issues Paper.

<u>Responses to Questions</u>

Chapter 3

3.1 Do interested parties have any comments on the proposed 'future with and without' assessment?

Macquarie supports the ACCC's intention to use a "future with and without" analytical framework to assess whether the exemptions will promote the LTIE.

3.2 Should the 'future with' exemptions scenario incorporate the existing conditions and limitations, as set out in the Tribunal's Metropolitan Orders and FADs? If any variation is proposed, alternative conditions or limitations should be specified.

Macquarie is of the view that the "future with" exemptions scenario should be aligned with the existing conditions and limitations as set out in the Tribunal's Metropolitan Orders and the Fixed FADs. This is because this represents the current known status of the exemptions. Macquarie does not believe that any variations should be made to the exemptions because any such variations would pre-empt the inquiry process.

[2] The annual change in Telstra's total basic access lines in service for the year ending 30 June 2011, i.e., negative 3.3% was the lowest reported in the past four years. (Source: Telstra Annual Reports 2008 – 2011)

Chapter 4

4.1 How much weight, if any, should the ACCC give to the ladder of investment theory in its 'with and without' assessment?

The ladder of investment theory is an essential component of the pre-NBN facilities based competition policy and regulatory framework and was a useful construct for the development of quasi-infrastructure competition in Australia over the last 10 years. The ladder of investment theory posits that regulated access to resale services should be progressively withdrawn so as to encourage access seekers to invest in their own network facilities. The existing exemptions have been in part justified on the basis of the ladder of investment theory.

Following the passing of the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010* the policy driven pursuit of facilities based competition gave way to a new framework for the regulated monopoly supply of access services. That is, it is no longer expected that access seekers will compete on the basis of different network facilities, rather they will compete on the basis of service. It seems inarguable that the ladder of investment theory has reduced relevance now that the Government's policy decisions are strongly favouring outcomes that mean that 'full' infrastructure competition (competing fixed access networks) and even 'quasi' infrastructure competition (competing ULLS providers) are unlikely to be economically sustainable in future.

The ladder of investment theory is no longer the pathway that access seekers are expected (and encouraged by regulation) to follow. That is, the ladder of investment theory is irrelevant as the telecommunications sector transitions to the NBN because investments in DSLAMs/MSANs are of no use in the NBN environment. Faced with scarce resources to invest, access seekers like Macquarie now prefer to make investments in projects which are NBN related such as content, transmission, data centres and cloud computing, rather than in DSLAMs/MSANs.

Accordingly, Macquarie is of the view that the ladder of investment theory should not have any weight in the ACCC's "with and without" assessment of the state of competition in customer access network markets. What this means for the ACCC is that existing regulations should be developed and adopted with an eye on the forthcoming changes. In that light, there is a serious question about the efficiency of encouraging duplicate investments in assets that will become stranded before the end of their useful life (even if the investment costs could be recovered) when there are existing sunk assets which already have the necessary service capability.

4.2 If the ladder of investment theory is adopted, how long should regulated access to the lowest 'rung' of the ladder (that is, resale services) be provided?

As per its response to question 4.1, Macquarie is of the view that the ladder of investment theory should not have any weight in the ACCC's "with and without" assessment. In any case, Macquarie is of the view that regulated access ought to apply until Telstra's copper network is completely decommissioned.

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Chapter 6

6.1 How does investing in DSLAMs/MSANs (in conjunction with purchasing the ULLS) allow access seekers to better serve their retail customers? Please give details.

It may be argued that investing in DSLAMs/MSANs (in conjunction with purchasing the ULLS) may allow access seekers to better serve their retail customers. However, Macquarie does not accept that an investment in DSLAMs/MSANs (in conjunction with purchasing the ULLS) will necessarily result in access seekers better serving their customers. What is relevant for better serving retail customers is an understanding of customer needs and providing services at appropriate quality levels which are responsive to such needs.

From an access seeker's perspective, investing in DSLAMs/MSANs (in conjunction with purchasing the ULLS) as opposed to purchasing a WLR service might better serve customers if such customers wish to upgrade from a dial up internet access service to an xDSL service. However, if such customers only sought voice services, then investing in DSLAMs/MSANs (in conjunction with purchasing the ULLS) would not improve service to customers. Moreover, a voice-only customer who migrates to a bundled voice and broadband service may suffer a degradation in the quality of the voice service if the voice service is VoIP. This is because VoIP calls are subject to more variation in call quality due to network congestion and the "best efforts" nature of the Internet. In addition, VoIP services are vulnerable to a loss of electricity supply and an inability to trace the location of the caller in an emergency.

It must also be recognised that a prerequisite for the supply of the ULLS is an unconditioned wire line between an exchange and an end-user's premises.[3] Where a pair gain system has been installed the prerequisite is not met. Moreover, the acquisition of ULLS is also constrained by long line length, poor copper quality and blocking. What this means is that an investment in DSLAMs/MSANs (in conjunction with purchasing the ULLS) is constrained to the extent that some lines will not support the provision of the ULLS. It is Macquarie's experience that up to 10 *per cent* of installations encounter problems with pair gain systems.

Where a pair gain system exists, there is no constraint on the line being used to supply WLR, LCS and PSTN OA resale services. Of further concern to access seekers is that where a pair gain system exists in an exempt area, there is no obligation for Telstra to provide the resale services. While Macquarie is of the view that the exemptions should not apply at all they certainly should not apply where a pair gain system exists.

6.2 On what service dimensions do resale-based access seekers compete in attracting and retaining retail customers?

In providing services to end-users via a resale service all RSPs use the same network facilities as each other. That is, there is only one network supplier, i.e., Telstra. As such, RSPs cannot (and do not) compete on the basis of differentiated networks. This will be the same situation with the NBN which will be a wholesale-only, open access network providing the same services to all RSPs. These situations are in contrast to mobile network operators who may compete on the basis of network coverage, reliability and performance.

As such, resale-based access seekers compete on a wide range of service dimensions which are focussed on customer service including:

[3] Australian Competition Tribunal, ACompT 4, 24 August 2009

- Empathy – individualised and caring attention to customers;
- Assurance – ability to convey trust and confidence to customers; and
- Responsiveness – willingness to provide prompt service to customers.

6.3 How important is the availability of (wholesale) resale services for new and potential new retail service providers in entering retail markets? How important is the availability of those services for established retail service providers? Please give reasons, supported, if possible, by examples.

The availability of (wholesale) resale services is fundamentally important for new and potential new RSPs and established RSPs alike in Australia's telecommunications sector. This is because of the significant competitive advantage that Telstra, as the incumbent operator, has in its ownership of ubiquitous network infrastructure. Without access to existing customer access networks and transmission networks, competitors would face enormous costs to replicate such networks which would create significant market entry barriers.

The importance of the availability of resale services is even greater in the transition to the NBN. This is because RSPs need to have a customer base that they can migrate to NBN services. There is a real danger that non-Telstra RSPs will be weakened by the effect of the exemptions which will constrain their ability to take advantage of the opportunities afforded by the NBN. In turn, competition will be constrained and the interests of end-users will be harmed.

6.4 How important are integrated product offerings, that is, the supply of a range of telecommunications services by a single supplier, to end-users? How significant is the availability of voice-only resale services in allowing access seekers to supply integrated product offerings? Please identify the types of customers that are most likely to require integrated product offerings and give detail about the services they require.

It is Macquarie's view that integrated voice and broadband service offerings meet the needs of some but not all end-users. The fact that 60 *per cent* of Telstra's fixed lines in operation are voice-only[4] suggests that integrated voice and broadband service offerings meet the needs of a minority of end-users.

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Macquarie believes that the end-users who purchase an integrated voice and broadband

[4] The Snapshot of Telstra's customer access network as at 31 December 2010 shows a total of 5,899,423 voice-only services out of a total of 9,792,636 services in operation. Source: accc.gov.au

service offering are likely to be cost conscious individual residential customers who want a single service which provides both voice and broadband services for home and home office needs. Many such customers may have migrated from a dial up Internet service to an xDSL service.

6.5 What market information is available, or could be made available, to assist the ACCC in assessing the importance of competitively-priced voice-only resale services in promoting competition at the wholesale and/or resale level?

Macquarie notes that the ACCC sought market information from a number of operators (including Macquarie) concerning fixed line geographic exemptions prior to the release of the Issues Paper. The information requested included:

- DSLAMs/MSANs supplied by ESA;
- number and type of resale services supplied by ESA by purchaser;
- prices of resale services and conditions of supply.

Additional information that Macquarie considers would be relevant to the ACCC's inquiry includes:

- the number of lines which are affected by a pair gain system within each exemption ESA;
- the number of lines within each exemption ESA which are unable to support the provision of ULLS because of inferior line quality, long line distance, blocking etc.;
- the number of services requested by access seekers in exemption ESAs which cannot be fulfilled by Telstra.

6.6 Does the existence of spare DSLAM/MSAN capacity in an ESA create the potential for resale services to be offered by access seekers with their own infrastructure?

In Macquarie's view the existence of a RSP with spare DSLAM/MSAN capacity is a long way from being able to claim a new source of supply of resale services. This is because it is unlikely to be economic, it involves competing with Telstra and requires taking up new business activities.

Macquarie is of the view that the cost inputs to provide a voice-only service over ULL would exceed the prevailing retail price, and therefore such a service is not economically viable. That is, given the cost of the ULL rental, the cost of providing voice switching equipment plus the retail cost of marketing the service and managing the customer, the voice-only service would be provided at a loss.

The RSP would have little incentive to supply wholesale services to other RSPs with which it competes in retail markets. That is, the RSP would *ceteris paribus* prefer to make its own retail sale than have it go to another RSP. Moreover, the RSP must face the reality that it would face competition from the dominant operator, i.e., Telstra and be prepared for Telstra to exercise its market power whenever and howsoever it may choose.

If a RSP was to become an access provider it would need to undertake a wide range of new business activities in which it has no business experience. Such activities would include:

- the development of operating and business support systems such as order processing, fault management, testing and billing for the services it would supply;
- the provision of services in locations and at quality standards that meet the needs of wholesale customers;
- the pricing of wholesale services; and
- compliance with applicable technical standards.

6.7 Are there any other conditions required to create the conditions for wholesale competition to develop?

The Issues Paper opines that the conditions for wholesale competition to develop are:

- the existence of spare DSLAM/MSAN capacity;
- a willingness to supply that spare capacity to other access seekers; and
- a willingness and ability to compete with Telstra.

In addition to the above, Macquarie is of the view that an essential condition which is also required for wholesale competition to develop is investor certainty. That is, potential entrants must have a stable investment environment with relatively few unknowns or uncertainties which reduces the riskiness of the investment.

Macquarie's assessment of these conditions is summarised in the following table.

Table 1: Assessment of Competition Conditions

Condition	Analysis	Result
Existence of spare DSLAM/MSAN capacity	• Issues Paper indicates existence of spare DSLAM/MSAN capacity	• Condition appears to be satisfied
Willingness to supply spare capacity	• The failure of RSPs with spare capacity to supply services indicates that such a willingness to supply does not exist • RSPs would need to undertake a wide range of new business activities without experience	• Condition not satisfied
Willingness to compete with Telstra	• The failure of RSPs with spare capacity to supply services indicates that such a willingness to compete with Telstra does not exist • RSPs already compete with limited success with Telstra in retail markets and are unlikely to find competing with Telstra in wholesale markets any easier	• Condition not satisfied
Investor certainty	• The transition to NBN has a wide range of profound impacts on RSPs creating an uncertain investment environment (refer to Macquarie's response to question 6.19)	• Condition not satisfied

Source: Macquarie Analysis

Macquarie is of the view that the conditions for wholesale competition are not fulfilled. This underlines the need to protect competition in the period during the transition to the NBN. That is, unless there is vibrant competition among RSPs, there is a danger that wholesale competition will not emerge.

6.8 What are the main reasons for access seekers' decisions to invest in their own DSLAM/MSAN infrastructure? What factors are taken into account in making the decision to invest? In your answer, please identify any factors considered to form barriers to investing and indicate how significant they are to the decision to invest.

The Issues Paper states that access seekers invest in infrastructure like DSLAMs and MSANs for two reasons, i.e., self-supply and to supply resale services to other access seekers.[5] In contrast to the ACCC's view, Macquarie believes that the primary reason why access seekers invest in infrastructure like DSLAMs and MSANs is for self-supply so that they can provide broadband services and bundles of broadband and voice services to their retail customers. In other words, Macquarie disagrees with the ACCC's view that access seekers invest in infrastructure like DSLAMs and MSANs to supply resale services to other access seekers.

In Macquarie's view the decision to invest in infrastructure like DSLAMs and MSANs must take into account a wide range of factors including:

- the capacity of Telstra being the dominant operator to use its market power to circumvent competition via predatory retail conduct;
- the availability of alternative investment projects in NBN related activities such as content, transmission, data centres and cloud computing;
- the impact of a government funded, legislatively supported new monopoly wholesale-only network being deployed;
- the expected current and future demand from end-users for bundled voice and broadband services;
- current and expected retail market price levels;
- the existence of alternative suppliers of services to meet end-user demand; and
- the capital cost, and the cost of maintaining, DSLAMs and MSANs.

In Macquarie's view, the key risks in investing in infrastructure like DSLAMs and MSANs arise from Telstra's market power. Key concerns are:

- DSLAM and MSAN infrastructure is located in Telstra's exchanges providing Telstra with knowledge of the investor's existence and its capacity together with effective control over physical access to the investor's infrastructure; and
- Telstra's capability afforded by its dominant market position to harm competition by for example, reducing retail prices, increasing the supply of alternative services and interfering with the provision of ULLS services.

[5] ACCC, Issues Paper, page 47

6.9 What is the cost of installing a DSLAM/MSAN? What are the costs of operating a DSLAM/MSAN once it is installed? What are the costs of expanding the capacity of a DSLAM/MSAN by adding ports? by adding voice cards? What associated infrastructure and/or equipment (such as switching equipment) is required and what are the costs of that infrastructure?

While Macquarie has installed and currently operates DSLAMs and MSANs, it is not in a position to provide relevant information. In particular, the costs incurred by Macquarie in installing DSLAMs and MSANs are out of date and Macquarie's accounting and information systems do not capture specific information concerning the operation of its DSLAMs and MSANs.

6.10 What are the costs of supplying resale services (wholesale line rental, local carriage and PSTN originating access services)? Please give details of the cost components. What other factors are taken into account in making the decision to supply resale services?

Macquarie does not supply resale services. As such, it is not in a position to address this question.

6.11 What, if any, technical limitations exist on the supply of resale services? Please give details.

Macquarie does not supply resale services. As such, it is not in a position to address this question.

6.12 What conditions are placed on the supply of resale services? Please give details. Why are these conditions imposed? If they are imposed for technical reasons, please give details.

Macquarie does not supply resale services. As such, it is not in a position to address this question.

6.13 How many wholesale suppliers of resale services operate in the exempt areas? Please provide numbers for each of the exempt ESAs, if possible, and name the suppliers of resale services.

There are no alternative suppliers to Telstra of the PSTN OA, LCS and WLR services in the exempt areas or the non-exempt areas. Moreover, there is no prospect of alternative suppliers entering either market. This conclusion is a result of:

- Macquarie's efforts to seek alternative suppliers for such services;
- the fact that other carriers who are potential sources of supply choose not to supply such services; and
- the fact that it is not economically viable for Macquarie to self-supply such services.

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6.14 How do the prices of, and conditions that are placed on, the supply of resale services, vary among different suppliers? Please give details.

Macquarie acquires resale services through a single source of supply, i.e., Telstra. This reflects Telstra's ubiquitous and dominant market position. If alternative sources of resale services were available, Macquarie would seek such services.

6.15 How do the incentives for supplying voice-only resale services differ from those for supplying bundled voice and broadband resale services? Please give details.

The incentives of the suppliers of resale services typically reflect the demands of access seekers. Access seekers acquire voice-only resale services to meet customer needs particularly in the context of rounding out a full package of a customer's communications requirements. Access seekers who acquire bundles of voice and broadband services typically seek to up-sell customers from voice to voice and broadband services to generate higher levels of revenue.

6.16 To what extent do bundled voice and broadband services substitute for voice only services? Please comment in relation to both retail and wholesale markets.

As per its response to question 6.23, Macquarie is of the view that there are separate markets for voice-only services and bundles of voice and broadband services. This implies that bundled voice and broadband services are not a substitute for voice-only services. This is supported by the reality that more than 60 *per cent* of Telstra's fixed lines in operation are voice-only as noted in Macquarie's response to question 6.4.

In Macquarie's experience at the retail level, there certainly are consumers for whom buying a bundle of voice and broadband services is not attractive. This includes lines for alarms and point of sale equipment and for redundancy. An increase in the price of voice-only services to wholesalers, which feeds through to retail prices, will not induce such customers to switch to a bundle of voice and broadband services. The reason may simply be that they are not interested in broadband services, they use wireless broadband services or acquire data services separately and prefer to continue to do so. Nonetheless, there may be some proportion of consumers that might switch if given a price incentive to do so.

Telstra's behaviour in increasing WLR prices suggests either that (a) it does not believe that consumers will substitute towards bundled services, or (b) it expects that driving customers onto bundles by increasing the price of WLR/LCS services might also drive more customers to its own retail operation.

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6.17 How competitive are wholesale markets for resale products, including voice only and bundled voice and broadband services? Please give reasons.

It is evident that the wholesale market for resale products is not competitive. This market comprises Telstra's supply of WLR, LCS and PSTN OA, the very limited self-supply of SingTel Optus using its HFC network and the self-supply by various ULLS-based access seekers.

SingTel Optus and ULLS-based access seekers have not been actively supplying wholesale services to access seekers. Any competitive constraint they apply to Telstra in the wholesale market would therefore operate indirectly, via the retail market. That is, Telstra's ability to push up wholesale prices for voice services is only subject to the quite weak constraint offered by non-Telstra RSPs switching their retail voice-only customers to SingTel Optus and other ULLS-access seekers. Telstra's wholesale market share subsequently approaches near monopoly levels.

In thinking about the state of competition in this market, the following should be considered:

- the barriers to entry for SingTel Optus or existing ULLS-based suppliers of retail voice and data bundles; and
- the barriers to entry for access seekers that currently acquire WLR, LCS and PSTN OA from Telstra.

Why SingTel Optus and ULLS suppliers are not particularly interested in supplying wholesale services to third parties is a matter of debate. It may be that these suppliers view the sale of wholesale services as a distraction to their core business of selling to retail customers. For example, selling wholesale services would require investments in ordering and billing systems, customer management, fault repair, and other wholesaling activities. Other ULLS entrants have chosen entry models that are simply not suited to wholesale supply.

In analysing competition in the wholesale market, consideration should be made of whether those access seekers who could not source the wholesale inputs from Telstra (at prices that would enable competition with Telstra in the downstream market) could enter the market directly. However, there are material barriers to entering the voice-only market. Such barriers include scale economies (minimum efficient scale) and commercial uncertainty caused by the NBN rollout.

Telstra has a very high (near monopoly) market share in the wholesale market and faces little or no direct constraint on its pricing of resale services. Combined with barriers to entry, this means Telstra has significant market power and will be able to exercise it in the wholesale voice market to favour its retail operation.

This conclusion about the state of competition in the wholesale market is reinforced by evidence on market performance. In particular, Telstra is (i) demonstrating that it can maintain wholesale voice prices significantly above regulated prices without attracting entry and (ii) can maintain discriminatory prices for business and residential users in exempt areas – even though in non-exempt areas the ACCC has set a flat rate for WLR, reflecting that there is no difference in the cost of supply of these services. In turn, it can be expected this market power will directly influence downstream prices and competition for services in fixed voice markets.

6.18 How viable is a wholesale-only business model—where an access seeker supplies only resale services to other access seekers and does not supply retail services—as a business strategy? Please explain.

Prima facie a wholesale-only business strategy would not appear to be commercially viable. This would involve a wholesale-only operator buying services only from Telstra given Telstra's market dominance. To be viable, such a business strategy would require:

- favourable pricing of services from Telstra; and
- ability to compete with Telstra in the provision of services to RSPs in terms of price, service responsiveness and service performance.

Macquarie considers it is unlikely that such requirements could be met.

6.19 How has the roll-out of the NBN changed the business strategies adopted by access seekers? For access seekers, please explain how your business strategy is affected by the NBN.

The introduction of the NBN is the biggest change to Australia's telecommunications sector since competition began more than 20 years ago. For access seekers like Macquarie it will mean in very simple terms a switch in the supplier of fixed line services from Telstra to NBN Co. However, this switch also involves a switch from copper to fibre infrastructure carrying with it a wide range of profound operational, competitive and strategic impacts.

In this context, an access seeker's business strategy is affected in many ways including:

- Access seekers will be purchasing different units of service which have a different pricing structure to provide equivalent services to existing customers. The switch in supplier means establishing new relationships for service ordering, billing, fault management etc

- Access seekers will need to decide whether they should buy services directly from NBN Co or if they should source services from an aggregator. This is because access seekers must purchase a sufficient volume of services from NBN Co to justify the fixed costs of a direct relationship with NBN Co.

- Access seekers will need to adjust their retail service and price offerings in the NBN environment to ensure that they remain responsive to customer demands. This is especially so as bandwidth speeds get faster and more widely available in the market.

- Infrastructure competition will be forced into upstream markets such as transmission services and away from customer access making access seekers much less likely to invest in DSLAMs/MSANs.

Macquarie acknowledges that the ACCC's argument regarding the threat of self-supply by wholesale customers operating as a constraint on Telstra's prices might have some relevance in a 'future without' the NBN. However, there is no such future.

The Government and NBN Co have prioritised the rapid roll-out of the NBN. The NBN is now well underway and enshrined in legislation[6]. Meanwhile, the NBN has gone live on mainland Australia[7] while network construction partners have been secured by NBN Co for both the fibre and fixed wireless rollout[8]. This reality cannot be ignored. The suggestion that the threat of wholesale customers moving to self-supply operates as a constraint on Telstra's prices for resale ignores the impact of NBN for the following reasons:

Wholesale customers cannot recover their investment

The ACCC has noted that:

"Ongoing DSLAM investment suggests that, despite uncertainty surrounding the NBN, access seekers intend to continue to invest in DSLAM/MSAN equipment where they consider it efficient to do so. The ACCC notes that some of these DSLAM investments may have been in response to the Regional Backbone Blackspots Program." [9]

The ACCC has also noted that:

"The potential for resale-based competitors to invest in their own infrastructure will place a constraint on behaviour in the wholesale market. The strength of this constraint on the exercise of market power in supplying resale services will depend on the relative costs and risks associated with self-supply compared to purchasing resale services." [10]

Macquarie submits that the risks associated with self-supply by wholesale customers for voice only markets is high given the strong possibility that assets will be stranded. As a result of the impending roll-out of the NBN, it is doubtful if there is time for wholesale customers to recover additional DSLAM investment prior to the advent of NBN. This is likely to result in such assets being stranded.

Potential loss of revenue from wholesale customers limited by NBN

The ACCC has argued that the threat of wholesale customers investing in their own infrastructure will restrain wholesale prices as Telstra will be faced with the prospect of potential loss of revenue from wholesale customers who move to self-supply. However, Telstra's potential loss of revenue from wholesale customers moving to self-supply is limited by the timeframe imposed by the NBN. The NBN provides a finite drop dead date beyond which Telstra cannot have any expectation of continuing to receive resale revenue, greatly

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[6] *National Broadband Network Companies* Act 2011 *and Telecommunications Legislation Amendment (National Broadband Network Measure – Access Arrangements)* Act 2011
[7] NBN Co Press Release, *National Broadband Network goes live on Mainland Australia,* 18 May 2011
[8] NBN Co Press Release, *'NBN Co & Silcar reach agreement to deliver value-for-money fibre rollout* and *NBN Co selects fixed wireless network partner for mid-2012 service start* both dated 1 June 2011
[9] Discussion Paper, page 35
[10] Discussion Paper, page 48

reducing the efficacy of any 'threat'.

When factoring in the NBN, Telstra's potential loss of revenue is only the difference between resale and ULLS price in the period from the wholesale customer's implementation of self-supply until the advent of the NBN. Telstra's potential loss as a result of self-supply does not continue into the future as would be the case absent the roll-out of the NBN. Macquarie is concerned that the ACCC has failed to take into account all of the consequences which flow on from the roll-out of the NBN.

Telstra has clear incentive to maximise retail market share in lead up to NBN

In September 2010 Telstra announced a $1 billion investment to fund its 2010/11 strategy to, amongst other things, aggressively grow its market share. In addition, Telstra has a clear incentive to maximise retail market share in the lead up to the NBN. In this context, the risk of Telstra engaging in sabotage conduct and price discrimination in order to favour its own retail business unit is extraordinarily high.

The short-term impact of Telstra ramping up prices for resale services is likely to be a loss of market share for wholesale customers. Telstra has a clear incentive to maximise retail market share in the lead up to the NBN, even if this would not have been sustainable behaviour absent the NBN. In other words, in the current environment, Telstra has a clear incentive to ramp up its prices in the exempt areas in the lead-up to the NBN where in other circumstances such conduct would not have been sustainable. In fact, Telstra has already engaged in such conduct in the exempt areas.

The ACCC needs to assume that Telstra will act in an anti-competitive manner in the exempt areas, not because Telstra's management is inherently malicious, but simply because this is the rational course of action for Telstra to take as a vertically integrated incumbent as it tries to maximise its retail share in the lead-up to the NBN. This behaviour is also consistent with Telstra's past course of conduct. The ACCC must not give Telstra this leverage and unfair advantage in the lead-up to the NBN and must not continue to incorporate the Exemption Determinations into the FADs.

Telstra receives disconnection fee regardless

Under Telstra's Subscriber Agreement, Telstra receives its 'disconnection fee' in respect of migration irrespective of whether it provides the wholesale service. Accordingly, Telstra will be indifferent if its wholesale customers move to a strategy of self-supply in the lead up to the NBN.

Broadly, Telstra will receive a payment from NBN Co for each active premises that it disconnects from its copper and HFC networks (irrespective of whether Telstra provides a wholesale or retail service to that premises, provided that it must have been providing "commercial service" of some kind). [11]

Telstra will still receive a bounty payment ('disconnection fee') from NBN Co, even where a wholesale customer is self-supplying using ULLS. Accordingly Telstra is indifferent as to whether wholesale customers self-supply in the lead-up to the NBN.

[11] Discussion Paper, page 179

6.20 How commercially viable is a wholesale-only business strategy expected to be on the NBN? How does such a strategy compare with an alternative strategy of supplying only retail services on the NBN? What factors will affect the commercial viability of a wholesale-only business strategy on the NBN?

As an access seeker, Macquarie welcomes the emergence of wholesale-only businesses on the NBN. However, of particular concern to Macquarie is the need to protect competition in the period during the transition to the NBN. There is a very real danger that if the exemption provisions remain in the Fixed FADs, Telstra will use this to aggressively retain its fixed line customer base with a view to migrating customers to the NBN and at the same time weaken the position of competing RSPs. In other words, wholesale-only business models will not eventuate unless there is vibrant competition among RSPs. Unless competition is protected now there is a real prospect that non-Telstra RSPs are driven out of the market or are too weak to support the emergence of wholesale-only businesses on the NBN.

The following table summarises Macquarie's view on the key differences in strategic factors that face operators choosing between wholesale-only supply and a retail-only supply on the NBN.

Table 3: Wholesale-only vs Retail-only Business Strategies on the NBN

Strategic Factor	Wholesale-Only	Retail-Only
Buyers	• Small number of RSPs	• Large number of end-users
Buyer Values	• Specialised functionality, service reliability, service performance	• Price, brand, service performance
Suppliers	• NBN Co, backhaul providers, systems integrators; in-house product / service developers	• NBN Co only
Operations	• Low volume, high margin	• High volume, low margin
Sources of Competitive Advantage	• Customised service offerings, relationships with RSPs, on-going product / service development	• Brand loyalty, price, service performance

Source: Macquarie Analysis

The analysis in the above table indicates that there are fundamental differences in business strategy between wholesale-only supply and retail-only supply on the NBN.

6.21 How have the exemptions affected the prices, product range or quality of services received by retail customers? Has the overall impact been positive or negative for end-users? Please distinguish between customer groups if the impacts have varied.

[Commercial in Confidence]

6.22 How important are barriers to new entry in the exempt areas compared with new entry in the non-exempt areas? Please identify the barriers that exist. How will these entry barriers affect the level of competition likely to develop on the NBN?

RSPs wishing to provide their customers with voice services face one source of wholesale services, i.e., Telstra and as a result of the FADs, differential prices between exempt and non-exempt areas. Clearly this creates a significant entry barrier. This will play out with RSPs moving away from the exempt areas and away from voice and broadband services. This means that in the medium-term there are likely to be fewer RSPs or a lower overall market share belonging to non-Telstra RSPs. As such, non-Telstra RSPs will not be in a strong market position from which to grow and develop as the NBN rolls out.

A case in point concerns Brunswick which is an inner suburb of Melbourne. An area of Brunswick is a first release site of NBN Co and services are now commercially available. The Brunswick ESA is an exempt ESA. With the impact of the exemptions locked into the Fixed FADs, Telstra has a strong incentive to raise the price of resale services in Brunswick to drive out competing RSPs. At the same time, competing RSPs have no incentive whatsoever to invest in DSLAMs and MSANs in Brunswick when NBN services are available to serve end-users. The likely outcome is that Telstra will build its customer base at the expense of non-Telstra RSPs leading to a weakening of competition and detriment to the interests of end-users.

The removal of the exemptions provisions in the Fixed FADs will ensure that non-Telstra RSPs will have access to resale services at regulated prices in Brunswick. In turn, this will curb Telstra's quest to build its customer base and to weaken competition.

6.23 Please comment on the appropriateness of the market dimensions described above for assessing the effects of the exemptions on the state of competition in relation to WLR, LCS and PSTN OA services.

Macquarie is concerned that a debate about market definition may overtake the essential matter of the ACCC's current inquiry. That is, the lack of constraint in wholesale markets in which WLR, LCS and PSTN OA services are supplied given Telstra's market position and the absence of alternative supply. Any market definition which defines this problem away is not helpful to an appropriate analysis of the strength of competition.

Macquarie considers that the ACCC's (and the Australian Competition Tribunal's) view on the definition of relevant markets is not appropriate. The ACCC essentially considers four markets as follows:

- the downstream supply of all fixed voice services;
- the upstream supply of wholesale inputs into the supply of fixed voice services including WLR, LCS and ULLS;
- the downstream supply of bundled broadband and voice services; and
- the upstream supply of bundled broadband and voice services.

The problem with this approach is that the fixed voice market is a subset of the bundled fixed voice and broadband market.[12] Instead, Macquarie believes that an appropriate market construct is:

- the downstream supply of fixed voice-only services;
- the downstream supply of bundles of voice and data services;
- the upstream supply of inputs to fixed voice-only services; and
- the upstream supply of inputs to bundles of voice and data services.

This approach to market construct is supported by consideration of a SSNIP by a hypothetical monopolist of wholesale voice services. This test was described in a recent merger decision *Australian Competition and Consumer Commission v Metcash Trading Limited [2011]* [13] by Emmett J as follows:

> *"A critical market definition test is the hypothetical monopolist test. That test involves determining whether a hypothetical monopolist supplier in a market could profitably impose a small but significant non-transitory increase in price [SSNIP], most commonly between five and ten per cent, for the supply of relevant products, or whether substitution by buyers or suppliers would make such an increase unprofitable. If the hypothetical monopolist supplier could profitably impose such an increase, to which I will refer as a relevant increase in price, the market is correctly defined."*

The relevant products subject to the SSNIP test must be defined. Market definition is purposive and in this case the purpose of market definition is to understand whether Telstra has a sufficient degree of market power in the supply of WLR and LCS for wholesale regulation to be maintained. Starting with the supply of WLR and LCS services, it can be observed that Telstra is an actual monopolist of WLR/LCS services, but that *in principle* it may be constrained by the self-supply of these services by competitors with other access networks or by those using ULLS as an input. The effectiveness of these constraints should be taken into consideration either in the market definition or in the analysis of competition in the defined market.

In applying the hypothetical monopolist test, directly observable market evidence can be used to find that an increase in prices for WLR/LCS by a hypothetical monopolist will not be sufficient to induce sufficient switching towards other sources of supply to make a price increase unprofitable. Through its actions in setting a wholesale WLR price of over $30 in exempt ESAs, Telstra has shown it can effectively increase prices by much more than a SSNIP[14] without direct constraint at the wholesale level, or indirect constraint deriving from the retail level (i.e., from consumers taking voice services from ULLS-based suppliers).

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[12] See Frontier Economics, Geographic exemptions for WLR, LCS and PSTN OA Services, A report prepared for Macquarie Telecom, June 2011, page 9

[13] FCA 967 (25 August 2011) at 153.

[14] Over and above the competitive level, for which the FAD price can be used as a proxy.

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Telstra would only implement such a price rise if it knows that the WLR price increase will not be defeated by substitution towards other wholesale services (perhaps supplied by other access seekers using ULLS), or bundles of voice and data at the retail level.

Macquarie's view is that this evidence suggests that it would be appropriate to define a separate wholesale market for voice services (WLR / LCS services) and that Telstra has market power in this market. The competitive constraint offered by suppliers using other access networks or ULLS-based networks must be weak.

6.24 Please comment on whether the retail and wholesale markets for voice and bundled services should be considered as separate markets or a single market. Reasons should be provided for your answer.

As per its response to question 6.23, Macquarie is of the view that voice-only markets are separate from the markets for bundles of voice and broadband services and that there is very limited or no competition at the wholesale level. Macquarie reiterates (as per its response to question 6) the fact that 60 *per cent* of Telstra's fixed lines in operation are voice-only. This fact clearly supports the argument that there is a separate market for voice-only services.

6.25 Please comment on whether voice markets are a separate market to the market for bundled services or whether they form a single market. Reasons should be provided for your answer.

As per its response to question 6.23, Macquarie is of the view that voice-only markets are separate from the markets for bundles of voice and broadband services.

6.26 How substitutable are mobile voice services and VoIP services for traditional PSTN voice services? Please comment on whether they should be included in the relevant market definitions.

Macquarie considers that there are significant differences between mobile voice services and PSTN voice services such that they are not adequately substitutable. In particular, the personal nature, and the convenience of mobility with mobile services contrasts with the location specific nature of fixed services. Moreover, call clarity and network reliability of mobile services tends to be below that of PSTN voice services. These features mean that many business customers will utilise both fixed and mobile voice services.

With regard to VoIP services, the distinction with PSTN voice services is less clear. As noted in Macquarie's response to question 6.1, the vulnerability of VoIP services to a loss of electric power and an inability to trace the location of the caller in an emergency contrasts with PSTN voice services. Moreover, VoIP calls are subject to more variation in call quality due to network congestion and the "best efforts" nature of the Internet. It is Macquarie's experience that VoIP services are not effective substitutes for PSTN voice services.

6.27 Please comment on whether voice markets, at wholesale and/or retail level, comprise separate residential markets and corporate/government markets.

In Macquarie's view, there are separate residential (or individual) and corporate / government market segments for voice services at the retail level. Some key points of difference are summarised in the following table.

Table 4: Retail Voice Market Residential vs Business / Government Segments

Factor	Residential	Business / Government
Buyers	• Individual persons	• Corporate entities and Government agencies with ACN
Key Buyer Values	• Price • Service performance	• Service performance • Service reliability • Service responsiveness
Requirements	• Discrete service offerings	• Total service solution
Buying Process	• Off - the - shelf	• Competitive tender
On-going Customer Support	• Zero	• Account management

Source: Macquarie Analysis

While identifying differences at the retail level between residential and business/government markets, the wholesale inputs sought by access seekers to serve these retail markets are the same. As such, there is no justification for Telstra to make distinctions at the wholesale level between residential and business/government markets.

6.28 Please comment on whether the exchange service area (ESA) represents the appropriate geographic dimension for assessing the effects of the exemptions on the state of competition in relation to WLR, LCS and PSTN OA services.

Macquarie notes that retail voice markets typically have a national dimension. Historically, competitors in the market in which WLR and LCS are supplied have generally sought to operate at a national level. One reason for wanting to provide services at a national level is reasonably obvious, i.e., many costs associated with providing retail services are fixed. For example, developing billing systems and customer software, advertising and establishing a brand presence all have a large fixed component. Providing services to all consumers in Australia therefore offers RSPs the maximum benefit – because it allows the spreading of fixed costs over as wide a customer base as possible.

In order to provide services to all consumers, a carrier needs to either self supply wholesale LCS and WLR services (whether on a full- or quasi-facilities basis), or to reach a wholesale agreement with a supplier of a WLR and LCS service. Given that Telstra is the only provider with national reach and existing wholesale capabilities, it historically has made sense for carriers to seek wholesale agreements with Telstra. In addition, this minimises the degree to which carriers need to incur the costs of drawing up and revising wholesale agreements.

At the wholesale level, it is arguable that competition might be more affected by the presence of competitive infrastructure. However, as there are overarching issues with own-supply, or wholesale supply, of WLR and LCS independent of region or exchange area, the particular wholesale geographic market definition is not critical to whether the exemptions should be incorporated into the FADs.

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6.29 Please comment on whether the geographic dimension of wholesale or retail markets for corporate and government services [is] broader in geographic scope than the ESA.

For similar reasons as discussed in its response to question 6.28, Macquarie is of the view that the geographic dimension of wholesale or retail markets for corporate and government services is national. That is, it is not the case that there exist differentiated services to meet the needs of customers located in specific geographic areas. Moreover, in the business / government market a single customer is likely to require services in multiple ESAs.

Closing

Macquarie would be pleased to address any queries that you may have concerning this submission or to provide any additional information which you may require.

Yours sincerely

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