

BUNDLING IN TELECOMMUNICATIONS MARKETS

ACCC DRAFT INFORMATION PAPER

PRIMUS TELECOM'S SUBMISSION

FEBRUARY 2003

Background

In January 2003 the Australian Competition & Consumer Commission (the “**Commission**”) released a draft Information Paper which outlined the Commission's proposed approach to assessing whether specific bundling conduct in the telecommunications industry is anti-competitive.

Primus is pleased to have the opportunity to make this submission in response to the Commission’s Information Paper.

Summary

Primus contends that:

- imputation testing alone, is inconclusive in actually determining the existence of anti-competitive behaviour;
- imputation testing is imprecise and the results are open to considerable interpretation;
- the current regulatory regime dealing with anti-competitive conduct is costly, slow, uncertain and practically unworkable;
- because imputation tests rely entirely on data and information supplied by the dominant carrier that it is open to considerable regulatory gaming;
- traditional methods of determining anti-competitive bundling behaviour (for example, imputation tests) will become less effective in markets where incumbent carriers are increasingly bundling telecommunications services with non-telecommunications services, such as entertainment. This will be further exacerbated where non-integrated carriers are excluded from providing all services in the bundle, such as is the case with pay TV in Australia;
- these practices together with the overall move toward convergence and where bundled services are becoming the norm (driven by package discounts and demand for single billing), increases the scope for anti-competitive bundling by dominant integrated carriers, and calls into question broader consideration of other regulatory measures. (Primus discusses alternatives in this submission), and;

- whatever regulatory tools are applied, that an *ex post* approach – as proposed by the Commission in its Information paper – is sub-optimal in preventing anti-competitive bundling and that *ex ante* remedies need to be given serious consideration as the preferred alternative.

Current regime (to assess anti-competitive behaviour) is inadequate

Primus contends that the current regulatory regime dealing with anti-competitive conduct is costly, slow, uncertain and practically unworkable. Even where competition notices have been brought (including Part B competition notices which have the evidentiary effect of reversing the onus of proof), outcomes have been relatively slow and affected parties have faced extended periods of uncertainty and potential contingent liabilities. Moreover, where matters have been litigated (including under Part IV and Part XIB of the TPA), affected parties have faced protracted periods of uncertainty in waiting for an outcome. It is not unusual for litigation involving Part IV issues to take more than five years to be finally resolved (the recent *Boral* matter is a case in point); litigation involving Part XIB matters *should* take less time due to the competition notice regime, although there are still plenty of ways in which the process may be gamed.

Primus believes that recent developments in service bundling – in particular the bundling of entertainment and telecommunications services together with the overall trend toward convergence – requires a broader consideration of regulatory measures to deal with the increased potential for anti-competitive outcomes.

Whilst Primus has no major concern about how the Commission would propose to use imputation testing to determine anti-competitive behaviour, Primus believes that such tests are highly imprecise and the results are open to considerable interpretation and regulatory gaming. Whilst the Commission's Information Paper provides a comprehensive assessment of imputation testing, Primus is concerned that it does not address other possible regulatory measures to deal with anti-competitive bundling.

Therefore, Primus proposes that the Commission extend its consideration beyond imputation testing alone to other regulatory devices such as reverse onus of proof provisions and ownership divestiture.

Options for effectively dealing with anti competitive bundling

Primus proposes that the following options be considered in endeavouring to inject some balance into the telecommunications-specific anti-competitive conduct regime (these proposals would sit in Part XIB of the TPA).

Reverse onus of proof

First, with respect to any telecommunications market the inputs for which are bottleneck facilities, a participant with a substantial degree of power in that market (whether as a supplier or acquirer of relevant goods or services) ought to be deemed to have engaged in anti-competitive conduct if it engages in conduct of the type described in sections 45, 45B, 46, 47 or 48 of the TPA (subject to

appropriate authorisation arrangements). It would be necessary for the Commission to declare which participants have the requisite degree of power in relevant markets (although this task would not be dissimilar from its previous declaration inquiries into services such as PSTN, ULLS and LCS). This would reverse the onus of proof and require such participants to show that such conduct would not have the effect or likely effect of harming competition. Primus understands that similar regimes apply in jurisdictions such as the United Kingdom and Hong Kong.

Refine the test of market power

Further or alternatively, the test for assessing market power for the purposes of section 151AJ(2) of the TPA ought to be reconsidered. For example, given experience to date, Primus considers it appropriate to assign greater emphasis to factors such as ownership of bottleneck facilities and the degree of vertical integration of firms. Primus considers that these types of factors (as opposed to imputation testing alone) represent clearer indicia of market power in telecommunications markets and such an overall approach is consistent with the High Court's reasoning in *Boral*. This approach would not require any legislative amendment; it could simply be incorporated into the Commission's final Information Paper.

Assessing the conduct of the firm with market power

Further or alternatively, the test for assessing whether particular conduct substantially lessens competition in a relevant market for the purposes of sections 151AJ(2) and (3) of the TPA ought to be reconsidered. Again, given experience to date, Primus considers it appropriate, where a firm has a substantial degree of power in a relevant market, that an *evident or likely* lessening of competition, rather than a *substantial* lessening of competition, would more properly protect and enhance competition in such markets (subject to a *de minimus* rule).

Excluding firms from certain activities

Further or alternatively, the Minister ought (by way of disallowable instrument) to have the power to exclude incumbent firms from certain spheres of activity where their inclusion would or would be likely to substantially lessen competition in a telecommunications market. Primus considers that Telstra's entry into the pay TV market would be an appropriate instance in which to exercise such a power¹.

Price squeeze via bundling of monopoly and competitive services

Primus also believes that the current Telstra Price Control Determination (2002), which was intended to allow Telstra supposedly to rebalance line access charges and local call charges, is allowing Telstra to bundle monopoly and competitive services creating the opportunity for it to cross-subsidise price discounts in competitive services from monopoly services.

¹ Primus refers to its public submissions in relation to the notification inquiry into the Telstra/Foxtel third line forcing conduct.

This type of conduct in particular has provided Telstra with a clear opportunity to impose a price squeeze on its competitors, for instance by:

- lowering retail prices for local call services, whilst maintaining wholesale prices for such services, and;
- alternatively, by lowering retail prices for other services within the “basket”, such as long distance and fixed-to-mobile, whilst maintaining wholesale prices for such services.

Primus is also concerned that the potential exists for Telstra to exploit the determination and engage in anti-competitive cross subsidisation by raising charges for the “monopoly” component that is, access, and reducing retail charges on competitive services. Such behaviour can facilitate a price squeeze or predatory pricing in the competitive services market.

Accordingly, Primus is most concerned about the price distortions which can result from the Price Control Determination and considers that it would be more appropriate for the relevant “basket” to be limited to local call services. Further possible measures in this regard include imputation testing to account for any price squeeze in relation to services within the “basket” and amending the pricing principles for local call services to take account of so-called rebalancing.

Commission’s interpretation of application of section 151 AJ

At page 9 of the Commission’s Information Paper, the Commission states that a carrier or CSP engages in anti-competitive conduct within the meaning of section 151AJ of the TPA if it has a substantial degree of market power in a telecommunications market and it engages in conduct in contravention of sections 45, 46 or 47 of the TPA. In fact, there is no requirement in section 151AJ that, in circumstances involving a contravention of sections 45, 46 or 47, the carrier or CSP must also have a substantial degree of market power. It is important that the Commission amend the Information Paper in this regard, so that the correct test is applied in assessing alleged anti-competitive conduct.

Imputation tests are inconclusive in determining anti-competitive behaviour

Primus acknowledges that whilst imputation tests are one tool for assessing anti-competitive behaviour by dominant carriers bundling services, it is clear that such tests can be wide ranging in nature, are imprecise and open to considerable interpretation. More importantly they are inconclusive. In a paper prepared by Steven King and Rodney Maddock, the authors state:

“While imputation rules are useful in detecting an anti-competitive price squeeze, the role of such tests needs to be kept in mind. If an integrated access provider violates one or more imputation tests then this is cause for concern. By itself it does not show that the firm has behaved in an unlawful way. The imputation tools

are diagnostic tests that should aid competition authorities but do not replace formal investigation².

Primus' concerns about the effectiveness of imputation tests are further reinforced when considering situations where non-integrated competitors cannot provide all the services in the bundled offering.

"The potential for an anti-competitive price squeeze increases significantly when non-integrated firms are only able to retail some of the products that the integrated firm can bundle together. In particular, the integrated firm can use bundling to limit the available market for non-integrated competitors."³

King also states that:

"In essence, bundling allows the integrated firm to price discriminate between customers with different mixes of values over the two products. Non-integrated firms do not have the same ability to price discriminate because they cannot sell the second product."⁴

"In contrast, when one product is only available at the retail level from the integrated firm, bundling may both raise the integrated firm's short term profit and make some customers better off in the short term. In this sense implementing a price squeeze through bundling product is much more likely when non-integrated firms can only sell some of the bundled products rather than all of the bundled products."⁵

King goes on to make the point that a standard imputation rule cannot be used to detect a price squeeze when there is asymmetric bundling such as when non-integrated competitors cannot provide all the products within the bundle. This is currently the case with regard to Telstra's bundling of PayTV and telecommunications services whereby carriers other than Telstra are unable to provide all services in the bundle, namely PayTV services.

Whilst Primus recognises that imputation tests can be extended to asymmetric bundling, Primus contends that the effectiveness of such testing comes under further pressure due to the additional complexities and the fact that it requires further modification of standard imputation testing.

"Note that a standard imputation rule cannot be used to detect a price squeeze when there is asymmetric bundling. If the integrated firm has some market power in product *b* and is able to make economic profits on this product then the integrated firm might still find the bundle profitable even if it had to "buy" upstream access for product *a* from itself. By mixing profits from product *b* with the potential imputed loss of product *a* the integrated firm is able to undermine the imputation test."⁶

"When an integrated firm can bundle different products then regulators face the risk that the firm will institute a price squeeze through the pricing of the

² "Imputation rules and a vertical price squeeze" Stephen P King and Rodney Maddock. February 2002. p57.

³ Section 2.3.2 Paper by CoRE Research "The Potential for Vertical Price Squeeze Under the Proposed Foxtel/Optus/Telstra PayTV Arrangements, a Report on behalf of AAPT Limited".

⁴ Page 12.

⁵ Page 12.

⁶ Page 13

bundle..... If the non-integrated firms can sell only some of the relevant bundled products then the regulator faces a more difficult problem."⁷

Primus is therefore not confident that imputation tests however applied will be an effective method of either preventing or dealing with anti-competitive bundling practices because inter alia, of the uncertainty of such tests .

As to the application of imputation tests, it is important to bear in mind that they apply to predatory pricing only (including vertical price squeezes); they do not apply to assessing whether conduct substantially lessens competition (which is the relevant test under s.47 and s.151AJ(2)(b)) of the TPA. For instance, in relation to section 47, according to NERA, imputation testing is not an appropriate test in relation to assessing whether bundling results in a substantial lessening of competition.⁸ Primus agrees.

Rather, in a matter such as the recent third line forcing notifications by Telstra and Foxtel, Primus submits that the Commission ought to have conducted an assessment of the relevant markets and the effect which Telstra/Foxtel's conduct would be likely to have had on such markets. Primus would invite the Commission to reconsider that matter in the light of comments made by the High Court in *Boral Besser Masonry Limited (now Boral Masonry Ltd) v Australian Competition and Consumer Commission* [2003] HCA 5. In that case, the High Court seemed sceptical of too readily importing rigid economic paradigms into questions of anti-competitive conduct:

"Section 46 does not refer specifically to predatory pricing, or recoupment, or selling below variable or avoidable cost. These are concepts that may, or may not, be useful tools of analysis in a particular case where pricing behaviour is alleged to contravene section 46. Care needs to be exercised in their importation from different legislative contexts. In the United States, for example, predatory pricing is often discussed in the context of monopolisation, or attempts to monopolise, in contravention of the Sherman Act 1890. In Europe, Art 86 of the Treaty of Rome prohibits conduct which amounts to an abuse of a dominant position in a market. We are concerned with the language of section 46. We are principally concerned with whether BBM had a substantial degree of power in a market, and whether, in its pricing behaviour, and its upgrading of its production facilities, it took advantage of that power...There is also a danger that principles relevant to the laws of other countries may be adopted uncritically and without regard to the context in which they were developed": Gleeson CJ and Callinan J at paras 124-126.

It would now appear from the *Boral* matter that the proper approach to be taken in assessing allegations of predatory pricing is to assess the overall effect of the conduct on competition in the relevant market, not to be over-dependent on technical and complicated pricing paradigms. Primus submits that the Commission ought to be especially cautious where the inputs for such tests are to be provided by the alleged offender.

⁷ page 15.

⁸ "In summary, determining whether a tying arrangement could be considered to have the purpose, effect or likely effect of substantially lessening competition will most likely require detailed consideration of the impacts, both beneficial and detrimental, in the context of the relevant market(s). In this respect, it is neither feasible nor desirable to develop analytical rules, such as the imputation tests, for assessing tying arrangements." *Anti-competitive Bundling Strategies – A report for the Australian Competition & Consumer Commission*, NERA, January 2003.

Primus also notes that the High Court has favoured a narrow market definition. Again, this is particularly relevant to assessing alleged anti-competitive conduct in telecommunications markets.

Implementation of imputation tests

To the extent that the Commission may use imputation testing, then Primus believes the use of record-keeping rules or tariff filing provisions are preferable to the use of information gathering powers such as those provided under Section 155 of the TPA.

Further, Primus urges the Commission to ensure that, given such tests are applicable only to integrated firms which have market power in downstream markets, that it not result in an additional regulatory burden on non-dominant carriers. As Primus understands the nature and role of imputation testing, this should not be an issue because it is the dominant carrier only that can provide the necessary data, perhaps with the exception of specific wholesale and retail pricing information of the non dominant carrier, which should not be a significant information requirement in any event.

Primus is also concerned about regulatory gaming and that imputation testing (if relied on solely) will tie up significant Commission resources and allow dominant carriers to "keep the regulatory busy".

Accounting separation and internal transfer pricing

Primus also believes that transparent internal transfer pricing mechanisms (as applied to carriers with market power) should also be considered as a regulatory tool to assist in identifying anti competitive behaviour resulting from cross subsidisation practices.

Primus remains concerned about the potential for Telstra to cross subsidise services particularly from monopoly or bottleneck based facilities to competitive services (Primus discusses this earlier in the paper under the Price Control Determination). Internal transfer pricing requirements would also provide transparency of Telstra's wholesale and retail pricing and may assist in identifying anti competitive cross subsidisation practices.

Further to this, to the extent that the proposed accounting separation arrangements may be applied, Primus would urge the Commission to consider the merits of requiring Telstra's pay TV service to be subject to the accounting separation requirements.