



TELSTRA CORPORATION LIMITED

**Submission to the Australian Competition
and Consumer Commission**

**Telstra's Local Carriage Service and
Wholesale Line Rental Service
Exemption Applications**

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Overview

The level of access regulation – which seeks to simulate a competitive market outcome – should be inversely proportional to the level of competition. Yet this principle does not seem to hold for access regulation administered by the Australian Competition and Consumer Commission (“**Commission**”) within the Australian telecommunications industry. Indeed, despite the intense growth in competition within the industry over the last 10 years, Telstra is now required to supply more regulated access services than it did when the competitive regime was established in 1997.

In a market economy, market forces deliver the most efficient outcomes – diversity of choice and competitive prices – for consumers. Regulatory intervention is only warranted in very limited circumstances - where for example, competition does not exist. Unnecessary regulation results in unnecessary costs, market distortions and inefficient outcomes, and will disincent innovation and investment. Rolling back unnecessary regulation removes superfluous costs and unshackles the affected market, enabling competitive forces to promote efficient outcomes.

Telstra believes that regulation governing access to the local carriage service (LCS) and wholesale line rental (WLR) should be wound back across large areas of metropolitan Australia. In these areas, facilities-based entry by Telstra’s competitors - including most strikingly the rapid development and deployment of DSLAM infrastructure in recent years - has made regulation of resale-based access in the form of LCS and WLR completely redundant.

Accordingly, Telstra has applied to the Commission seeking exemptions from regulation of LCS and WLR in 371 competitive exchange areas (“**ESAs**”) across metropolitan Australia (“**Exemption Area**”).

Within the Exemption Area, the LCS and WLR no longer constitute the kind of “enduring bottleneck” to which the declared access provisions of Part XIC of Act were originally intended to apply. Continuing to regulate access to the LCS and WLR in the Exemption Area:

- ignores the existence of other declared services such as the Unbundled Local Loop Service (ULLS) that enable the provision of substitutable services to those offered via the LCS and WLR (in effect regulating the same bottleneck twice);
- ignores the presence of significant alternative infrastructure (primarily Digital Subscriber Line Access Multiplexers (DSLAMs), but also HFC and wireless networks), which provide a competitive platform for the delivery of substitute services; and

- ignores the competitive environment made possible by the deployment of this infrastructure, and in particular the ability of competitors to provide facilities-based services in direct competition to those offered via the LCS and WLR services.

Recent comments by the Commission in the course of the Fixed Services Review show it recognises that it is no longer appropriate to declare access to the LCS and WLR in areas where alternative infrastructure exists. These statements must now be matched by action by the Commission in granting our exemption request, and allowing competition in the marketplace to thrive without regulatory interference.

Market-based competition is the best control on pricing and supply of services, not artificially-constructed rules imposed by a regulator. The facilities-based competition that is evident in the Exemption Area allows a great degree of innovation and product differentiation — much more so than the mere re-badging of Telstra’s retail services which is promoted by the declaration of the LCS and WLR. By removing the regulation of LCS and WLR in the Exemption Area, the Commission will allow the facilities-based competition that exists now in these areas to further develop and flourish. This in turn will encourage efficient investment in the provision of the types of products and services demanded by consumers, both now and in the future.

The primary (but not the only) platform for such competition is the expanding roll-out of DSLAM-based infrastructure by alternative network operators. DSLAM-based infrastructure can provide both voice and broadband services in competition with Telstra’s own services.

Aside from the technical capabilities of DSLAMs, their importance as a competitive constraint arises from the relatively low cost at which they can be deployed. The economics of DSLAM-based infrastructure are such that there are no material barriers to entry and expansion of competition in the Exemption Area. This is demonstrated by the ubiquitous roll-out of DSLAMs throughout the Exemption Area.

Each ESA in the Exemption Area has at least one DSLAM deployed by a competitor to Telstra. Three quarters of the ESAs have DSLAMs deployed by at least two competitors. The rollout of this DSLAM-based infrastructure has been particularly rapid in the last 18 months, and market announcements by several players indicate that this trend is set to continue apace.

Other alternative telecommunications infrastructure has also been deployed by many companies in these ESAs in recent years. This includes the presence of HFC networks (such as the Optus HFC network) and fixed wireless and mobile networks. These substitutes to Telstra’s network add weight to the case for the immediate removal of the unnecessary regulation of LCS and WLR in the Exemption Area.

Because the declaration of the LCS and WLR in the Exemption Area is no longer necessary, continuing to regulate access to these services in these ESAs will only result in unnecessary costs and inefficiencies, harm the competitive process, and discourage efficient investment.

On the other hand, granting these Exemption Applications will promote competition and the efficient investment in (and use of) infrastructure in the Exemption Area. In all, by removing unnecessary costs and distortions, and by promoting greater competition, granting these Exemptions will promote the long term interests of the end users of telecommunication services.

Introduction

In this submission, Telstra sets out the evidence and arguments in support of the both the LCS and WLR Exemption Applications. Telstra provides this single submission in support of both Exemptions because:

- access seekers will generally acquire both services together from Telstra;
- the LCS and the WLR are invariably offered as a bundle to consumers in the retail market; and
- the arguments in support of both Exemption Applications are the same.

Accordingly, in this submission, when Telstra says that the Exemptions will promote competition and the efficient use of and investment in infrastructure, it is saying that the exemption of each of the LCS and the WLR will promote those things, and therefore, those things will also be promoted (and promoted to a greater extent) if both Exemptions are granted.

The remainder of this submission comprises five sections.

In **Section 1**, Telstra sets out the nature and basis of the Exemption Applications, outlining the regulatory background to the applications, the ESAs included within the Exemption Area, and the legal principles the Commission must apply in assessing these Exemption Applications.

The next two sections present evidence of competitive infrastructure deployment and competition within the Exemption Area. Specifically:

- **Section 2** outlines the extensive rollout of alternative infrastructure within the Exemption Area. This is driven by the roll-out of DSLAM-based infrastructure and the economics of deploying this infrastructure.
- **Section 3** outlines how the deployment of this competitive infrastructure has resulted in real competition in the supply of the LCS and WLR and related downstream services in the Exemption Area.

In both of these sections, Telstra explains how DSLAM-based infrastructure is the key driver of competitive entry in the Exemption Area. Further, evidence is presented showing that once an initial DSLAM-based entry has occurred, this provides tangible and sufficient evidence of

the contestability of the ESA such that the application of the declared access provisions for the LCS and WLR in that area are no longer required.

Having established that the supply of the LCS and WLR can no longer be considered an enduring bottleneck in the Exemption Area, the submission then explores the consequences of either continuing to declare access (Section 4) or granting the Exemption Applications (Section 5):

- **Section 4** sets out the harmful consequences of continuing to regulate access to the LCS and WLR in the Exemption Area, where competition exists.
- **Section 5** shows how granting these exemption applications will promote a competitive environment, encouraging competition in the relevant markets; and ensure the efficient investment in (and use of) infrastructure. That is, Telstra will show how granting these exemptions will promote the long term interests of end users.

In preparing the Exemption Applications, Telstra has relied upon a report from Dr Paul Paterson, a leading economist with substantial expertise in telecoms regulation (“**Paterson Report**”). The Paterson Report together with several statements and a report on factual matters relied upon by Dr Paterson are set out in Annexures A to J to this submission.

Confidentiality

This submission has all the confidential information deleted and thus may be disclosed publicly. Telstra will provide the confidential version of this submission and the information contained in it to interested parties subject to those parties signing appropriate confidentiality undertakings.

The confidentiality undertakings do not limit the extent to which interested parties, and the Commission, can analyse and comment on the content of this submission. Rather they are intended to prevent the distribution and use of the confidential material contained in this submission for purposes other than participating in the Commission’s public inquiry relating to the Exemptions.

1 The nature and basis of these Exemption Applications

Telstra is seeking exemptions from Part XIC in respect of certain geographic areas in which it is evident that competition exists. The seeking of an exemption in a limited geographic area is not novel, and is consistent with previous approaches taken by the Commission and with recent statements made by it. For example, the Commission previously granted an exemption from the standard access obligations in respect of the supply of the LCS in the CBDs of Sydney, Melbourne, Brisbane, Adelaide and Perth following an application by Telstra.¹

Subsequently, in its *Local Services Review - Draft Decision on whether or not the ACCC should extend, vary or revoke its existing declaration of the local carriage service* (March 2006) (“**2006 Draft Decision**”) the Commission revisited its declaration of the LCS and set out its intention to re-declare the service everywhere outside of the CBD areas. It noted, however, that:²

“... while it is not appropriate at this stage to exempt large or discrete portions of the market through the service description, where an applicant could demonstrate that an exemption could be justified on the basis of effective competition in any given subregion, an exemption would provide a superior tool for targeted withdrawal.”

Thus, although in its final decision on its *Local Services Review (Local Services Review - Final Decision* (July 2006) (“**2006 Final Decision**”) the Commission announced its decision to re-declare the service, it explicitly noted:³

“...the availability of a formal ex post process available through the granting of exemptions from the Standard Access Obligations. This would allow applicants to seek exemptions from regulation for particular regions.”

The Commission has continued to expressly endorse a “targeted” approach in its latest *Fixed Services Review - A second position paper* (April 2007) (“**FSR - Second Position Paper**”), where it stipulated that:⁴

“...where appropriate, the Commission will geographically delineate markets on a narrower basis than a ‘national scope’, to reflect that competition has emerged (and is likely to continue to emerge) unevenly in different geographic regions of Australia. In

¹ “The Future Scope of the Local Carriage Service – Final Decision”, ACCC, (July 2002) (“**2002 Final Decision**”).

² 2006 Draft Decision, p. 9.

³ 2006 Final Decision, p. 10.

⁴ FSR - Second Position Paper, p. iv.

particular, the Commission proposes to base future market definition exercises at the ‘local exchange level.’” (emphasis added)

The Exemption Area

The Exemption Area comprises 371 ESAs throughout metropolitan (Band 2) Australia.⁵

The majority of ESAs in the proposed Exemption Area are in the six major metropolitan areas — Sydney, Melbourne, Brisbane, Perth, Adelaide and Canberra (Figure 1). The Exemption Area also includes ESAs in Hobart, Darwin and regional centres including Geelong, Ballarat, the Gold Coast and Launceston.

Within the proposed Exemption Area, there are just over 5.2 million PSTN services in operation (SIOs). This equates to 77 per cent of metropolitan services or just over 50 per cent of all PSTN SIOs. The Exemption Area includes ESAs located in each State and Territory (Table 1).

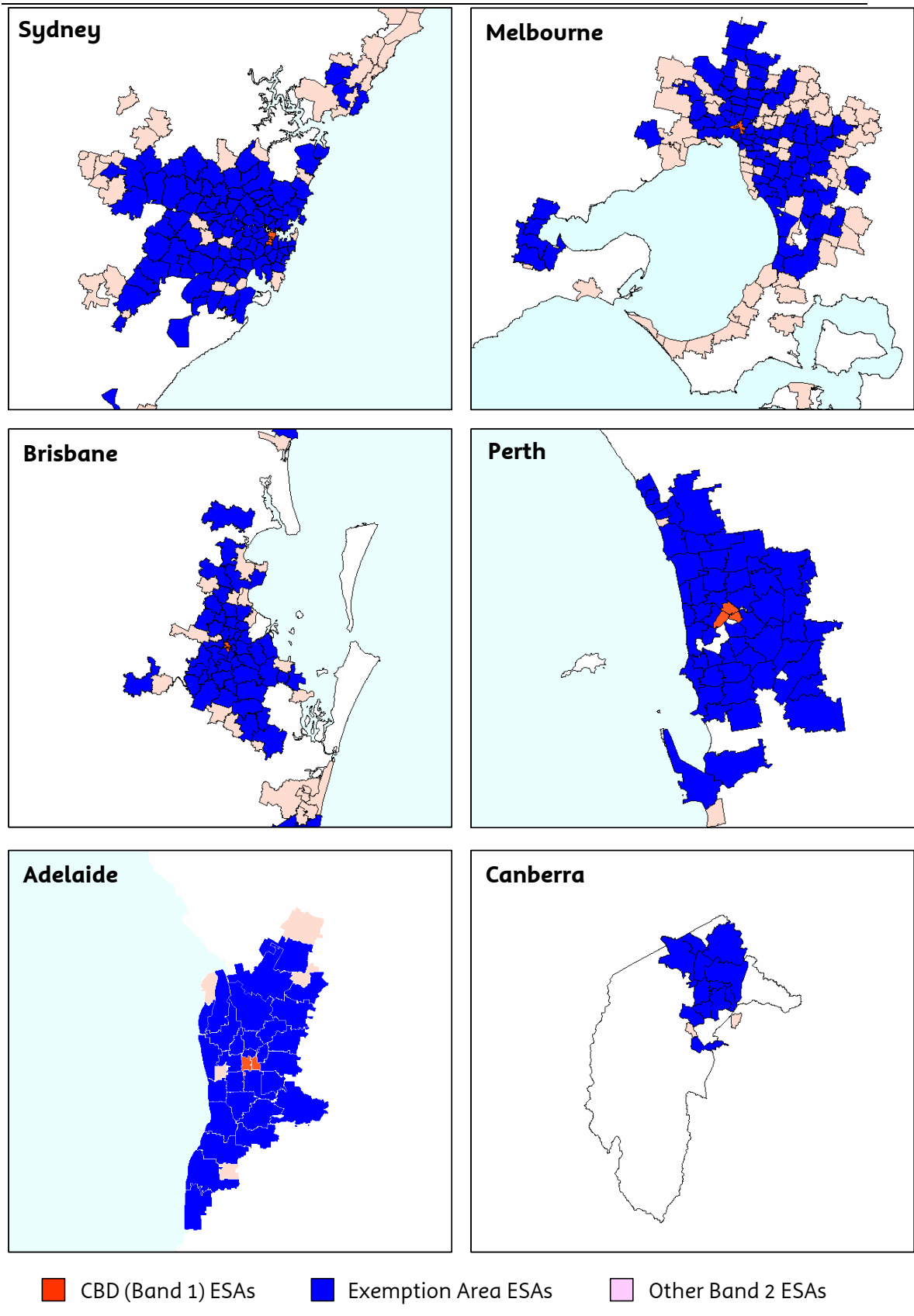
Table 1: State and territory breakdown of proposed Exemption Area

	ESAs included in the Exemption Area	Services covered by the Exemption Area ^a
NSW	117	1,792,203
Victoria	89	1,234,346
Queensland	64	851,937
WA	54	664,044
SA	32	518,971
Tasmania	3	36,639
Northern Territory	1	14,119
ACT	11	119,976

^a Refers to PSTN basic access services in operation in Exemption Area ESAs, June 2007

⁵ Each of the ESAs in the Exemption Area are classified as Band 2 ESAs for the purposes of Telstra’s Ordering and Provisioning Manual as at the date of the Exemption Applications.

Figure 1: Exchange Service Areas in proposed Exemption Area, major metropolitan areas



Exemptions on an ESA by ESA basis and market definition

Analysis for these Exemption Applications was undertaken at the ESA level. This allows the most thorough consideration of differences in the provision of services to be considered. As the Commission itself noted,

“The potential advantages of using the ‘exchange’ as the geographic unit is that it may closely reflect the extent to which there are different competitive conditions in different geographic regions, compared to arbitrary delineations between different geographic levels such as between CBD, metropolitan and rural & regional areas.”⁶

In the Paterson Report, Dr Paterson also considers the ESA to be the appropriate geographic level. Although his economic analysis suggests that a broader market might be more appropriate, Dr Paterson states,

“...in this particular context, which is an application for Exemption Orders, an exchange based approach is more appropriate, for the following reasons:

- *First, it is consistent with the context of the current enquiry, in the sense that Exemption Orders would not reasonably be capable of implementation in an area defined any more narrowly;*
- *Second, it reflects the topology of the incumbent network, and hence the units that the incumbent is likely to see as being at direct risk of stranding; and*
- *Third, it minimises the risk that the choice of too-broad a geographical market definition will inappropriately lead to a decision not to forbear, when forbearance would have been desirable”⁷*

For the sake of simplicity, Telstra has limited the scope of the Exemption Applications to ESAs that fall within metropolitan areas of Australia (Band 2). Telstra may, at a later date, focus on the extent to which competition has developed outside these areas.

A more detailed treatment of market definition issues (including the appropriate geographic scope of the market) relevant to the Exemption Applications is set out in Appendix 1.

However, Telstra is of the view that under Part XIC, the Commission need not come to a definitive stance on market definition for the purposes of considering the Exemption Applications. In the 2006 Final Decision the Commission commented at page 29 that:

⁶ FSR – A Second Position Paper, p. 38.

⁷ Paterson Report, pp. 19-20.

“In identifying relevant markets, Part XIC of the TPA does not require the ACCC to take a definitive or determinative stance on market definition ...

Furthermore, over time, declaration itself might affect the dimensions of these markets, particularly in relation to the functional dimension. Accordingly, market analysis under Part XIC should be seen in the context of providing an analytical framework to examine how declaration would promote competition rather than in the context of developing ‘all purpose’ market definitions.”

Telstra agrees with this assessment.

The legal basis for these Exemptions

The Commission can only grant the Exemptions if they promote the long term interests of end-users (“LTIE”). However, if the Exemptions *do* promote the LTIE (and Telstra says that they do for all the reasons in this submission), the Commission must grant them.

In deciding whether the Exemptions will promote the LTIE, the Commission must have regard to the objectives of Part XIC of the Act, being:⁸

- promoting competition in markets for carriage services and services supplied by means of carriage services;
- achieving any-to-any connectivity for carriage services involving communication between end-users; and
- encouraging the economically efficient use of, and economically efficient investment in, the infrastructure by which carriage services are supplied.

That is why much of this submission will present evidence and reasoning as to why granting the Exemption Applications both promote competition and promote efficient use of and investment in infrastructure (Telstra believing that the achievement of any-to-any connectivity is largely irrelevant for present purposes).

Interpreting the LTIE

The approach to interpreting the LTIE test has been considered by the Australian Competition Tribunal (“**Tribunal**”), and can be summarised as follows:

⁸ See s152AB of the Act.

- (a) the granting of an exemption in respect of the supply of a service will be in the LTIE where competition in the market for the supply of a service is already effective, and is likely to remain so;
- (b) whether exemption is in the LTIE must be assessed over the long-term, giving sufficient time for existing and potential competitors to adjust to the outcome, make investment decisions, and implement growth and entry/exit strategies;⁹
- (c) to the extent that exemption would have mixed effects, in terms of potential tension between the competition and efficiency limbs of the LTIE, regard must be had to the overall or net effect of exemption;¹⁰ and
- (d) competition is promoted for the purpose of the LTIE test if exemption would create conditions or an environment for improving competition from what it would be absent an exemption (as opposed to demonstrating the existence of actual competition).¹¹

The effect of these principles is that it is not necessary to show that there will be an immediate, instantaneous, or short-term increase in competition to prove that the Exemptions are in the LTIE. Rather, it is clear that an exemption must be granted *now* if it is more likely than not that exemption would create *conditions or an environment* that will result in an *overall or net increase* in the LTIE over the *long-term*. The Tribunal recognised this could mean “some years” in the future.¹²

It follows that even if the Commission is concerned that the Exemptions may bring about some short-term or transient deficiencies in competition, the Commission must still grant the Exemptions if the overall or net effect of the Exemptions is in the LTIE.

A more detailed analysis of the legal aspects of the LTIE test (together with an examination of how it has been interpreted by the Tribunal and the Courts) is at Appendix 1 to this submission.

Validity of Part XIC

In current proceedings before the High Court of Australia, Telstra has challenged the validity of Part XIC of the Act as it relates to the ULLS and the LSS. However, Telstra recognises that, notwithstanding these proceedings, the Commission has decided to continue to act on the basis that Part XIC of the Act is valid. Accordingly and, on that basis, Telstra makes these Exemption Applications in respect of the LCS and WLR. In the event that the proceedings

⁹ See *Seven Network Limited (No.4)* [2004] ACompT 11 (“**Foxtel decision**”) at [120].

¹⁰ See *Foxtel decision* at [122].

¹¹ *Re Sydney Airports Corporation Ltd* (2000) 156 FLR 10 at [123].

¹² See *Foxtel decision* at [120].

result in a determination that Part XIC of the Act is invalid as it relates to the ULLS and the LSS, the Exemption Orders in respect of the LCS and WLR proposed by Telstra would cease to have effect.

2 There is extensive competitor infrastructure in the Exemption Area

In this section, Telstra sets out evidence on the extent of competitive infrastructure deployment in the Exemption Area. In particular, evidence is presented on the prevalence of DSLAM-based infrastructure and the impact of an initial competitive DSLAM deployment in an ESA.

Within the Exemption Area, the LCS and WLR services can no longer be considered an enduring bottleneck to the supply of fixed voice services. In each ESA within the Exemption Area, there is now alternative infrastructure – enabling the provision of substitute services to the LCS and WLR, and a competitive market for fixed voice and related services.

In fact, the ESAs in the Exemption Area are now hotbeds of competition with extensive deployments of competitive infrastructure (Table 2). Telstra *conservatively* estimates that there are more than a dozen companies using their own infrastructure to supply voice and broadband services within the Exemption Area (see Box 1).

Table 2: Alternative infrastructure in the Exemption Area, by type

	Number of customers covered ^a	Percentage of Exemption Area covered ^b	Number of companies deploying this technology	Supplies voice (including local calls) and data services
DSLAM-based infrastructure	5.2 million	100%	11 ^c	✓
HFC/Optical fibre cable networks	3 million	57%	4	✓
Fixed Wireless Networks	3.5 million	67%	4	✓

^aRefers to the number of PSTN SIOs served by ESAs in the Exemption Area in which competitor infrastructure has been identified. ^bRefers to the percentage of ESAs in which competitor infrastructure has been identified. ^cTelstra has identified 11 companies (or related companies) that have deployed DSLAMs in ESAs in Exemption Area. This figure is conservative (see Box 1).

Source: [c-i-c].

Box 1: Data used in preparing this application

The data used in this report to determine the location of competitive infrastructure has been sourced from publicly available sources and (to a lesser extent) third-party competitive intelligence reports.

There is no single, public source of data on the deployment of telecommunications infrastructure at the necessary level of geographic disaggregation necessary for the present purpose. Further, the information that is available through public sources often only presents a partial picture of the extent of deployment of infrastructure, its capability and the types of downstream services which are provided on that infrastructure – some of which is commercially confidential. As such, there is continued uncertainty as to the extent of competitive infrastructure deployment, and reports may differ. For example, in the recently released report on telecommunications infrastructure by the Australian Communications and Media Authority (ACMA) and the Commission, it was claimed that 19 providers have deployed DSLAM-based infrastructure. In this submission, Telstra has only relied on the DSLAM deployments of 11 different companies (or strategically-aligned partners) in its ESA-level infrastructure data. Telstra believes the Commission itself is sympathetic to these difficulties – as evidenced by its proposed infrastructure audit discussion paper issued in March this year, whose primary purpose was to provide appropriate data regarding of the state of deployment of alternative infrastructure in discrete geographic areas to better inform the Commission in reviewing whether continued regulation is necessary.

Telstra considers that the claims made in this submission and in the Paterson report as to the coverage of competitive infrastructure within the Exemption Area are conservative and are likely to understate the true extent of competitive infrastructure build in Australia.

For example, Dr Paterson has been careful to ensure that DSLAM infrastructure utilised by resellers (including Exetel and GoTalk which resell Optus services) is not 'double counted'. Telstra has also been conservative in counting distinct infrastructure installation in services offered by providers who have announced strategic alliances. There is extensive evidence that DSLAM-based infrastructure has been deployed by AAPT, Powertel and iiNet. Telstra has taken the stance of counting only a single competitive DSLAM, where we have evidence that one or more of these three companies is providing DSLAM-based services (such as ADSL2+ services). This is due to recent announcements surrounding the purchase of Powertel by AAPT. There have also been recent announcements that Powertel will wholesale services on iiNet infrastructure.

Although Telstra is confident that this conservative estimate does not overstate the true number of competitor DSLAMS throughout the Exemption Area, it is nonetheless **open to the Commission to issue a notice under section 155 of the Act** upon Telstra or other infrastructure providers to seek full and accurate data on the extent of infrastructure-based competition within the Exemption Area based on Telstra's confidential wholesale customer information.

See further: Paterson Report, footnote 34, p. 28; Speech by Optus CEO to Communications Alliance 6 Dec 06 (available at <http://www.optus.com.au>), https://home.aapt.com.au/At_AAPT/What_s_news/2007/AAPT_and_PowerTel_tie_the_knot_.html, http://www.iinet.net.au/about/investor/260506_powertel_announce.pdf

The most common alternatives to Telstra's PSTN for the supply of basic access, local calls and related services are DSLAM-based infrastructure, cable networks and fixed-wireless networks. While not the focus of this paper, mobile wireless networks also provide substitutable voice calling services and are increasingly (with the development and deployment of high speed mobile data networks) providing substitutable broadband services. The significant penetration of mobile services across Australia provides a further layer of competition for voice services provided via LCS and WLR.

The most prominent type of infrastructure enabling the supply of alternatives to LCS, WLR and related services is DSLAM-based infrastructure (Box 2).

Box 2: DSLAM-based infrastructure

Throughout this submission, the term “DSLAM-based” refers to infrastructure and services that utilise Telstra’s ULLS or LSS access products to install exchange-based equipment (for example, DSLAMs) capable of offering voice or high speed broadband services (or both) to end users. For example, references to “DSLAM-based” competitors are references to competitors using either the ULLS or the LSS, in conjunction with DSLAMs, to provide services to end users.

The ULLS provides access seekers with the copper wire between Telstra’s local exchange and the end-user. This enables access-seekers to provide both a standard telephone service (“STS”)-equivalent service and broadband services that can be directly sold to end-users or wholesaled to resellers. The High Frequency Unconditioned Local Loop Service (otherwise known as the Line Sharing Service or the “LSS”) provides similar functionality to a ULLS service in relation to the provision of broadband (ie high frequency) services, but where the PSTN voice service is still provided by another party.

These services have different capabilities, however they both provide access to the underlying CAN infrastructure, allowing competitors to provide an array of fixed-line services in competition to those offered by Telstra (at both the retail and wholesale level) at an ESA by installing a DSLAM and associated equipment. Furthermore:

- Although LSS services cannot offer traditional, POTS voice services, operators can (and do) provide competitive voice services by utilising VoIP telephony. As such, both ULLS and LSS can be used to supply voice and data services to end users.
- Dr Paterson finds that any economic or technical barriers to carriers switching from LSS to ULLS services are easily surmounted and therefore immaterial.

iiNet Chief Executive Michael Malone has recently been quoted as saying that “*I think ULL is the right solution and where we want to see our customers*”^a notwithstanding that iiNet’s current DSLAM deployment is primarily underpinned by utilising LSS. As noted by Dr Paterson in his report, LSS entrants can quite viably shift to ULLS-based supply and directly compete with the LCS and WLR services because ULLS is a viable means of competitive entry. Despite the fact that a number of additional costs must be incurred (such as switching and termination costs, which are not insurmountable), the move to ULLS from LSS provides numerous benefits for competitors who have already incurred the cost of deploying a DSLAM in an ESA:

- Reduced cost of providing a broadband and telephony bundle ;
- Increased control over the type of services that can be delivered; and
- Increased scope to differentiate its products:

For these reasons, it is both reasonable and appropriate to aggregate LSS-based and ULLS-based competitor DSLAMs in aggregate for the purposes of the Exemption Applications. To that end, references to DSLAM-based infrastructure in the remainder of this submission should be read as references to DSLAMs connected to ULLS or LSS networks.

^a Sainsbury, M., “Telstra’s rivals get rent cut” *The Australian*, 29 June 2007.

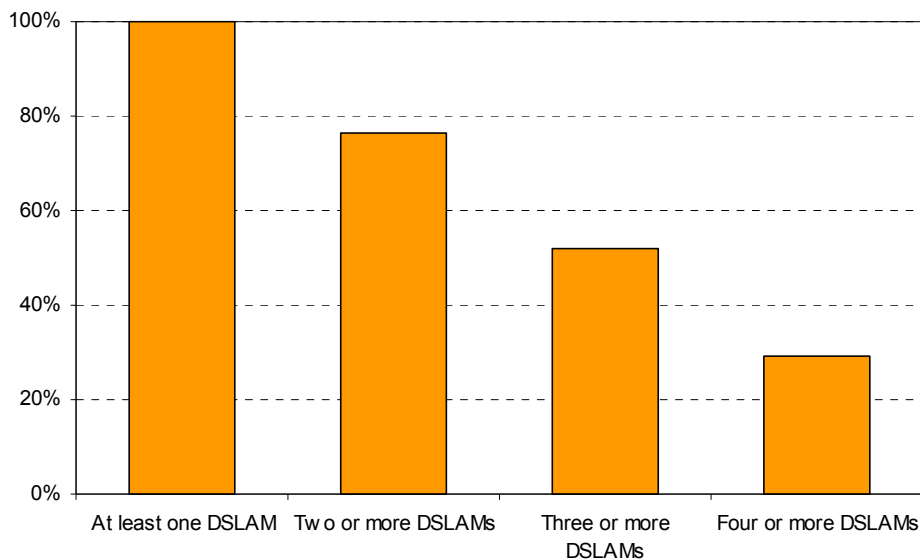
See further: Paterson Report, Appendix D. [c-i-c] Telstra, Submission in Response to the ACCC Discussion Paper in relation to the Redecoration of the LSS (May 2007,), refer section 3.1.1.1 at pp. 13-14 (substitutability) and section 3.2.2.1 at pp. 23-26 (switching from LSS to ULLS).

DSLAM-based infrastructure is used to supply high speed broadband services and fixed voice telephony (using traditional circuit-switched technology and VoIP) at the wholesale and retail level:

- In every ESA in the Exemption Area there is at least one provider (in addition to Telstra) utilising DSLAM-based infrastructure to supply voice and data services. Operators of DSLAMs include Optus, AAPT-Powertel, Primus, Nextep and Agile (Internode) who each operate extensive DSLAM-based networks across Australia.
- In more than three quarters of the Exemption area there are two or more DSLAM-based networks operated by different service providers. There are four or more DSLAM-based networks in over 100 ESAs (29 per cent of ESAs) (see figure 2).
- Importantly, several of Telstra’s competitors have now installed infrastructure throughout the Exemption Area. Based on publicly available information it appears that Optus, AAPT-Powertel/iiNet, Primus, Nextep and TPG have DSLAM infrastructure in over 100 ESAs.¹³

This indicates the ease with which DSLAM-based operators can grow within an ESA once the initial conditions for deployment of a single non-Telstra DSLAM are met.

Figure 2: Percent of ESAs in the Exemption Area covered by competitor DSLAMs



Source: Telstra analysis based on [c-i-c].

¹³ [c-i-c]. Note: unless the context expressly indicates otherwise, references in this submission to a certain number of DSLAMs deployed in an area generally refers to competitor DSLAMs, that is, in addition to Telstra’s own deployment.

Aside from DSLAM-based infrastructure, there is also evidence of widespread deployment of cable and fixed wireless networks in the Exemption Area (Table 3), none of which is reliant upon LCS or WLR to deliver services to end-users. Four jurisdictions — NSW, Victoria, Queensland and the ACT have access to all DSLAM-based, cable and fixed wireless infrastructure. In 87 per cent of ESAs there are at least 2 alternative networks (DSLAM-based, cable or fixed wireless).

Although it is not necessary in order to demonstrate that granting the Exemption Applications promotes the LTIE (as, for the reasons set out in the Paterson Report, the presence of an initial DSLAM is enough), the presence of these alternative networks can only serve to reassure the Commission of the desirability of granting the Exemptions.

Table 3: Competitor infrastructure in the Exemption Areas, by State and Territory

	Number of competitors identified	DSLAM-based infrastructure	HFC/fibre-optic network infrastructure	Fixed wireless infrastructure
NSW	11	✓	✓	✓
Victoria	10	✓	✓	✓
Queensland	9	✓	✓	✓
WA	6	✓	✓	
SA	8	✓		✓
Tasmania	2	✓		
Northern Territory	1	✓		
ACT	8	✓	✓	✓

Source: [c-i-c].

Cable based networks are present in 205 ESAs in the Exemption Area.¹⁴ This includes the Optus HFC network, which is present in almost 200 ESAs and passes 2.2 million addresses¹⁵ (Table 4). These networks are used to supply fixed voice telephony (using traditional circuit-switched and VoIP telephony) and high speed broadband services, and can therefore also be regarded as alternatives to the LCS and WLR in supplying downstream markets.

Table 4: Availability of Optus' HFC Network in the Exemption Area

	Number of ESAs covered by the Optus HFC network	Percentage of ESAs contestable by HFC
NSW	88	75%
Victoria	66	74%
Queensland	41	64%
Total	195	72%

Source: Paterson Report, Table 3, p. 32.

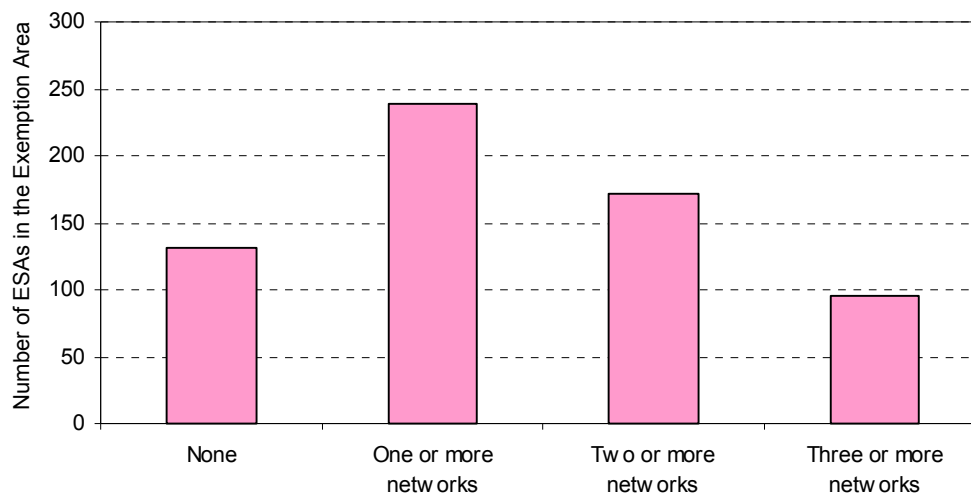
¹⁴ [c-i-c].

¹⁵ Optus, Media Release *Cable & Wireless Optus demonstrates success of bundling strategy* (31 March 1999).

Although the Optus HFC network is the most prevalent HFC network in Australia (other than Telstra’s own), it is worth mentioning that there are a number of other HFC networks which also act as substitutes to Telstra’s LCS and WLR and which also demonstrate that Telstra’s competitors consider these investments to be viable. These include the HFC networks belonging to TransACT, Neighbourhood Cable, and E-Wire, which cover specific areas across Australia.

Fixed wireless networks are present in 239 ESAs in the Exemption Area (see Figure 3). Operators include iBurst, BigAir and Unwired. These networks are used to supply high speed broadband services at the wholesale and retail level and enable the provision of voice services through VoIP telephony (see further Section 3).

Figure 3: Number of fixed wireless networks in each ESA in the Exemption Area



Source: [c-i-c].

There is continuing expansion of competitive infrastructure

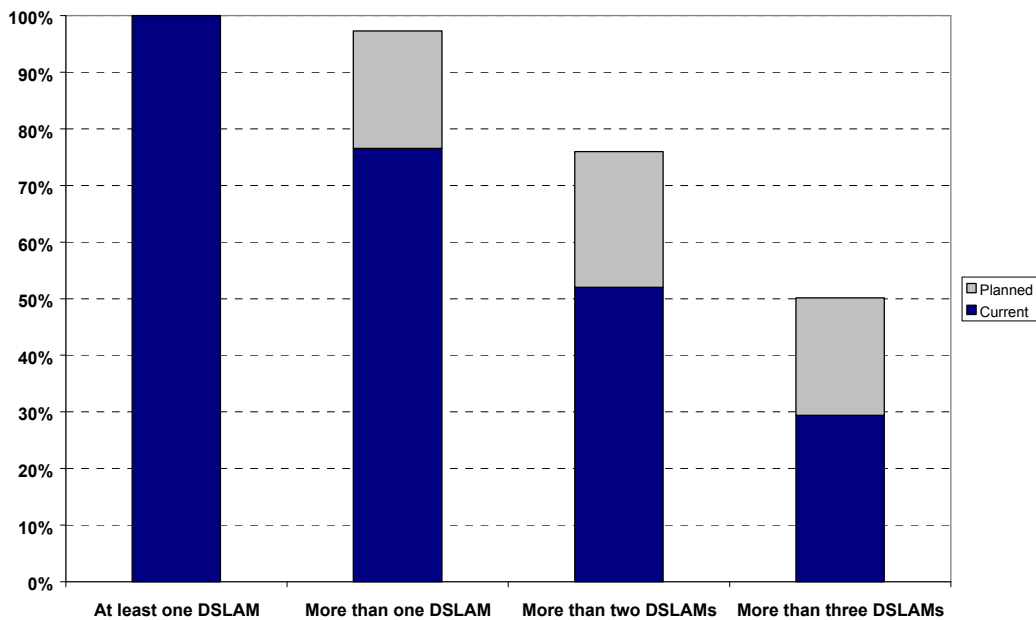
As stated previously, there has been a significant expansion in the deployment of alternative infrastructure over the past ten years. Based on publicly available deployment plans and company announcements, there is no sign that this expansion will slow going forward:

- Optus has announced plans to roll-out DSLAM-based infrastructure to an additional 90 ESAs by the end of 2007-2008, taking their total deployment to 366.¹⁶
- Primus has recently re-commenced its national ADSL2+ deployment, announcing that it will roll-out its DSLAM equipment to 100 additional ESAs over the second half of 2007.¹⁷

¹⁶ Reported by engin ltd. In their announcement to the ASX, “Engin uniquely positioned to deliver broadband services to the digital home, 12 June 2007, available at http://www.engin.com.au/Downloads/11_asx_announcement_120607_TiVo_ADSL2_final.pdf

- Within the Exemption Area, the depth of DSLAM-based infrastructure will also increase (see Figure 4). More than 70 per cent of ESAs in the Exemption Area will have at least three competitive DSLAM-based infrastructure offerings available based on current, publicly-released deployment plans¹⁸.

Figure 4: Percentage of ESAs in the Exemption Area covered by competitor DSLAM-based infrastructure, current and planned services



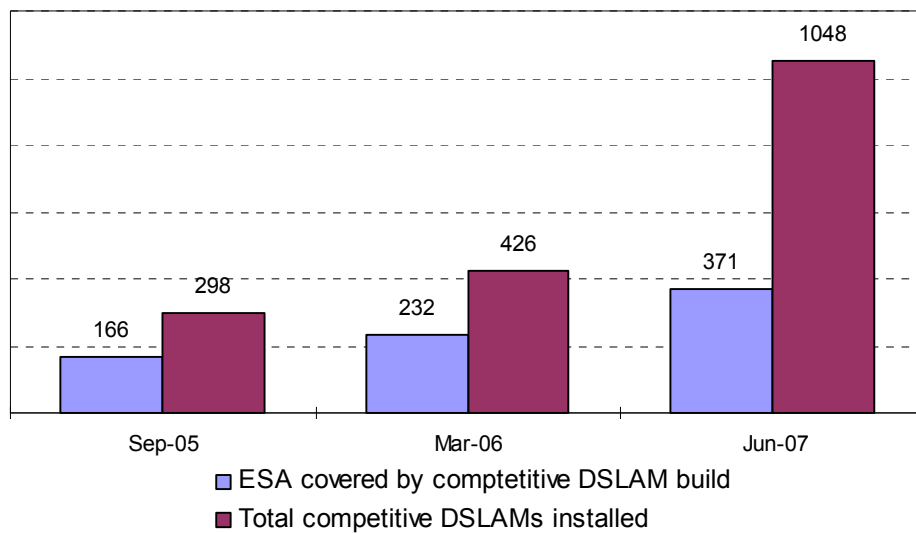
Source: Paterson Report, Figure 3, p. 29.

These projected deployments mirror the recent growth in the number of DSLAM-based offerings in the Exemption Area. Since September 2005, the number of ESAs in metropolitan areas with at least one DSLAM-based competitor has more than doubled (Figure 5). Over the same period, the number of competitor DSLAMs in the Exemption Area has more than tripled.

¹⁷ Communications Day, Issue 3066, 28 June 2007.

¹⁸ That is, including Telstra, there will be at least four infrastructure based operators in these areas

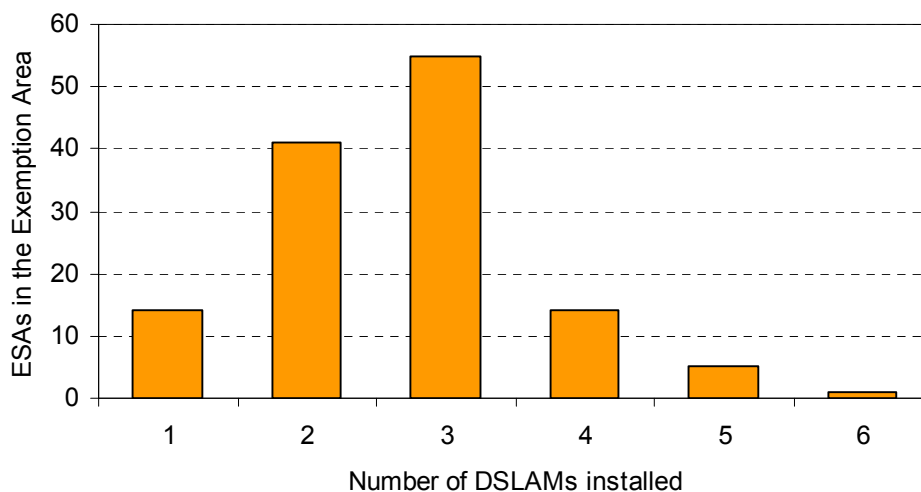
Figure 5: Growth in DSLAM infrastructure within the exemption area



Source: Telstra analysis based on [c-i-c].

The recent growth in DSLAM deployment also reveals that the deployment of an initial DSLAM in an ESA is likely to be followed by subsequent DSLAM deployments from other operators. In March 2006, 130 ESAs in the Exemption Area had only a single DSLAM deployed. By June 2007, 90 per cent of these ESAs had an additional DSLAM installed, with 20 of those ESAs having had three or more additional DSLAMs deployed (Figure 6).

Figure 6: Number of (non-Telstra) DSLAMs deployed in June 2007 in ESAs in the Exemption Area identified as having only one active (non-Telstra) DSLAM in March 2006



Source: Telstra analysis based on [c-i-c].

The ongoing expansion in DSLAM-based infrastructure is particularly significant given that the Commission's decisions to accept or reject the Exemption Applications are likely to be

handed down towards the end of calendar year 2007 (if not early calendar year 2008). Although there is sufficient evidence to grant the Exemptions in the Exemption Area immediately, by the time the Commission reaches its decision, the case will only have become more compelling due to this continued growth.

DSLAM-based infrastructure is the key

Importantly, although almost every ESA in the Exemption Area contains multiple alternative infrastructure networks, it is the presence of only one alternative DSLAM-based network that acts as a competitive constraint on Telstra. The importance of DSLAM roll-out has been recognised by the Commission:

“...Declaration of the unconditioned local loop service (ULL) in 1999 offered competitors an alternative to purchasing wholesale services from Telstra, by allowing them to deploy their own infrastructure - such as DSLAMs - directly in Telstra’s local telephone exchanges.

This offered the opportunity to significantly reduce a competitor’s reliance on Telstra’s network. By using their own DSLAM infrastructure, access seekers can differentiate their services, potentially offering higher bandwidth data communications and voice services than they could by simply re-selling Telstra’s wholesale service offerings.”¹⁹

Expert analysis undertaken for Telstra by Dr Paterson finds that the presence of an initial DSLAM-based network operator in an ESA provides a sufficient competitive constraint on Telstra’s WLR and LCS products.

Dr Paterson’s opinion, which Telstra adopts for the purposes of the Exemption Applications, is that from an economic and practical perspective, an ESA with one actual DSLAM-based competitor DSLAM deployed would be sufficient to constrain Telstra’s behaviour in relation to the LCS and WLR in that ESA.²⁰ The reasons underlying this view can be summarised as follows:

- from an economic perspective, there are no material barriers to DSLAM-based entry or expansion;
- from a practical perspective, the mere existence of one DSLAM-based competitor DSLAM demonstrates that there are no material barriers to competitive entry; and
- from a factual perspective, available empirical evidence is consistent with the view that actual entry has occurred.

¹⁹ Ed Willett, Commissioner, speech “Understanding competition in the growth of Australian Broadband”, 21 November 2006

²⁰ Paterson Report, pp. 45-46.

Furthermore, the acceptance of the Exemption Applications based on this decision rule would be a “low risk” decision for the Commission for the following reasons:²¹

- there are no material barriers to DSLAM-based entry or expansion for Telstra’s competitors, and hence Telstra faces pricing and provision constraints from both existing DSLAM-based competitors and the entry threat of new competitors;
- the retail services that can be provided by the LCS and WLR can be effectively replicated by alternative fixed-line networks, including the Optus and other HFC networks. In New South Wales, Queensland and Victoria, over 70% of ESAs in the Exemption Area are also covered by the Optus HFC network;
- wireless networks are also becoming increasingly tenable alternatives to the LCS and WLR;
- over three-quarters of the ESAs in the Exemption Area already have two or more DSLAM-based competitors in addition to Telstra;
- planned DSLAM build in 2007 that has been publicly announced has not been included in the exemption footprint. However, if it were included, the number of ESAs in the Exemption Area that would have two or more DSLAM-based competitors would be almost 100 per cent; and
- given that many competitors have deployed DSLAMs, competition will be maintained even if a particular competitor exits the market, as it is likely that they will be replaced by another DSLAM-based operator.

Accordingly, Telstra submits that the within the Exemption Area, which is based on the decision rule of at least one actual competitor DSLAM in an ESA, conditions exist that support Telstra’s strong belief that granting the Exemption Applications would have the effect of promoting competition in the medium to long-term, and ultimately, be consistent with the LTIE.

²¹ Paterson Report, pp. 46-47.

3 There is competition throughout the Exemption Area

In this section, Telstra sets out evidence on the extent and drivers of competition in the markets for the LCS, WLR and related services in the Exemption Area. In particular, evidence is presented on the competitive impact of an initial competitive DSLAM deployment in an ESA. Evidence is also presented on the impact of VoIP services and fixed to mobile substitution.

The markets in which the LCS and WLR are supplied are contestable and workably competitive. Evidence of this includes the changes in market shares over time and the current market offerings, the existence of numerous substitution possibilities (including VoIP and mobile telephony services) and the lack of barriers to entry for potential competitors willing to enter the market — driven primarily by the economics of DSLAM-based competitor entry. These factors provide sufficient constraints on Telstra in respect of its pricing and provision of the LCS and WLR, such that declared access to these services is no longer warranted in the Exemption Area.

As is well known, substitution possibilities on both the supply and the demand side provide an effective constraint on an incumbent firm's market power. In this respect, DSLAM-based infrastructure and other fixed networks (such as the Optus HFC) can act as alternative means for providing downstream services supplied via the LCS and WLR. Further, there is a range of alternative access technologies available such as mobile wireless networks that are already providing directly substitutable services and are likely to increasingly constrain Telstra's pricing and supply of the LCS and WLR.

It is indicative of the level of competition in the Exemption Area that in these areas Telstra has a lower retail market share (relative to its national average) in fixed line services.²² It is also instructive that the total number of SIOs serviced by Telstra's PSTN (retail and wholesale) has fallen more dramatically in the Exemption Area than for the rest of the network. Since March 2004, the number of PSTN SIOs in the Exemption Area has fallen by almost [c-i-c] per cent, compared to [c-i-c] per cent for the rest of the network (Figure 7). This is unsurprising, given the multiple fixed wireless and fixed-line alternative networks in the Exemption Area providing competitive alternatives to the PSTN.

Figure 7: Decline in PSTN services in operation over time, Exemption Area compared to PSTN as a whole

[C-I-C]

²² [c-i-c]

The presence of competitive infrastructure is also driving competition at the wholesale level in the Exemption Area using DSLAM-based infrastructure. In the wholesale market, several operators are offering substitutes to the wholesale the LCS and WLR services in the Exemption Area:

- Optus offers wholesale access and local calling products throughout its DSLAM-based, ULLS network in direct competition with Telstra's WLR and LCS offerings.
- AAPT-Powertel, Nextep (a subsidiary of NEC) and Optus offer a range of wholesale products on their extensive DSLAM-based networks across Australia. These platforms enable resellers to provide high speed broadband services, access services and fixed voice services (using VoIP) which provide competitive substitutes to retail products utilising the LCS and WLR.
- Several operators also offer wholesale broadband services (including Optus, AAPT-Powertel, Primus, Nextep, and Agile). These services allow resellers to offer VoIP telephony products and data products in direct competition to services offered via WLR, LCS and related products.

At the retail level, competition is even more intense. Within the Exemption Area, many companies utilise their own infrastructure or resale services acquired from alternative infrastructure providers, to offer competitive fixed voice, high speed broadband and related products.²³ Typically companies offer bundled voice services (basic access, local calls, long distance, international and fixed to mobile) which is the most dominant form of competitive offer. Only a fraction of customers in the retail market purchase basic access and local calls without purchasing the complete bundle of voice products.²⁴

VoIP is an emerging competitive substitute to traditional fixed voice services

VoIP telephony products are increasingly being offered as fully-featured substitutes to traditional PSTN telephony. It is estimated that there are over 260 VoIP providers throughout Australia, with almost 100,000 paid VoIP services in operation, which is estimated to climb to more than 2.8 million services by 2011.²⁵

VoIP services are offered by several companies utilising DSLAM infrastructure throughout the Exemption Area, including AAPT, Primus, Optus, iiNet, Soul and Internode. It is also being

²³ Aside from the 11 DSLAM operators identified by Telstra as having their own DSLAM infrastructure in the Exemption Area, resellers (or companies Telstra did not include as 'operators') include Exetel, Netspace, GoTalk, Westnet, LetsGo, G-Node, Wild IT&T and iSeek, amongst others.

²⁴ Paterson Report, p. 14.

²⁵ Market Clarity, *The Australian VoIP Services Market 2004-2011*, 7 March 2006, as reported at <http://www.marketclarity.com.au/news/06-03-22.cfm>

offered by fixed wireless operators (BigAir). VoIP providers have specifically and aggressively targeted the fixed line services market (and in some cases Telstra directly).²⁶

In a recent review of the retail price controls, a number of industry participants (including Telstra, Optus and Chime) made submissions recognising that rapid growth in VoIP technology will pose a significant challenge to fixed line services in coming years.²⁷ While the Commission did not consider that VoIP posed a significant threat to traditional fixed-line services at *that* time, it did note that an issue for future determinations would be “*the effect of new technologies, such as Voice over Internet Protocol (VoIP), on pricing structures*”²⁸. More recently, Commissioner Ed Willet stated;

*“We have seen a shift from standard voice over telephone to an emphasis on broadband and all that flows from it, including internet, internet protocol television (IPTV), streaming of audio visual content and voice over internet protocol (VoIP).”*²⁹

Other recent developments in relation to the continued roll-out of VoIP include:

- Optus has announced that it intends to launch VoIP services to SME customers nationally in the second quarter of 2007, claiming that the deployment will be the first large scale roll-out of the technology in the market.³⁰
- Sholl Communications has linked with Mobi’s Fabfone VoIP business to increase economies of scale and scalability. According to Mobi Chairman Fabio Pannuti, “*It is the board of Mobi’s intention to be a market leader in the VoIP space by Q4 2008*”.³¹
- Hutchison and Skype have announced a deal to enable Skype VoIP services on mobile handsets using the Hutchison 3G network.³²
- In March 2007, engin launched a new \$14.95 per month unlimited local and national VoIP plan. engin reported a total subscriber base of 52,500 for the end of December 2006, up 35% over the last sixth month period. It has also added a further 5,500 customers in January and February of 2007.³³ engin is also set to be the first

²⁶ “Telstra loses fight to block VoIP ads” Sydney Morning Herald, 23 September 2006.

²⁷ ACCC, *Changes in the price paid for telecommunications services in Australia 1997-98 to 2003-04: Report to the Minister for Communications, Information Technology and the Arts*, (March 2005), pp. 17 and 93.

²⁸ ACCC, *Changes in the price paid for telecommunications services in Australia 1997-98 to 2003-04: Report to the Minister for Communications, Information Technology and the Arts*, (March 2005), pp. 1 and 93-100.

²⁹ Ed Willett, Commissioner, speech “Understanding competition in the growth of Australian Broadband”, 21 November 2006.

³⁰ Communications Day, Issue 2990, 7 March 2007.

³¹ Communications Day, Issue 2987, 2 March 2007.

³² See VOIP News, *Mobile VOIP phones soon*, (22 February 2006). Available at: www.voipnews.com.au/content/view/348/107/; and *Wireless Carrier Offers Wholesale VoIP*, (4 May 2006). Available at: www.voipnews.com.au/content/view/1038/107/

³³ Communications Day, Issue 2986, 1 March 2007.

Australian company offering mobile VoIP, having announced a Nokia handset distribution deal and mobile calling client.³⁴

Commentary around a recent Commission decision relating to the price Telstra can charge iiNet for the LCS and WLR services highlighted the commercial reality that VoIP is increasingly seen by customers and service providers as a substitute to traditional, PSTN-based voice services:

“Despite the local call hike, Malone [managing director of iiNet] said that for the majority of its customers the headline rate is for line rental. He added the increases in local call costs at least provided an incentive for the uptake of VoIP. iiNet currently has 50,000 VoIP customers and charges 15 cents for national calls.”³⁵

Even more revealing were comments from VoIP operator Engin when it recently released a plan to offer a ‘triple-play solution’ which included a VoIP telephony offering using the Optus ULLS network:³⁶

*“Engin CEO Ilkka Tales sees the combined VoIP, broadband and Tivo offering opening up new markets. It will pitch the expanded offering as a **“true PSTN replacement,”** (emphasis added)*

According to Tales, ‘there are a number of overseas models that demonstrate how DSL can help aggressively drive the penetration of broadband, particularly when combined with a quality broadband telephony offering. Engin will allow customers to ditch the middleman and have their line setup exclusively for broadband and internet telephony, cutting both telephone and access costs and allowing customers a single point of contact if they need help.’³⁷

Fixed to mobile substitution

With mobile subscription penetration reaching saturation,³⁸ mobile services are increasingly becoming substitutable for fixed-line services. As a result, mobile originated voice calls provide an effective substitute for fixed voice calls, therefore providing a competitive

³⁴ Communications Day, Issue 2966, 23 January 2007.

³⁵ Communications Day, Issue 3056, 13 June 2007.

³⁶ Engin, ASX Announcement: *Engin uniquely positioned to deliver broadband services to the digital home*, 12 June 2007, available at www.asx.com.au

³⁷ Communications Day, Issue 3056, 13 June 2007.

³⁸ This was recognised by the Commission’s consultant, wik-Consult GmbH (“**WIK**”) in *Mobile Terminating Access Service: Network Externality and Ramset Pricing Issues: A Consultancy Report to the Australian Competition & Consumer Commission in relation to Optus’s and Vodafone’s Undertakings in relation to the Domestic Digital Mobile Terminating Access Service*, (3 November 2005) (“**WIK Report**”), pp. 48-49. Optus has estimated mobile penetration rates to be as high as 97% as at 31 December 2006 - source: SingTel Optus, *Management discussion and analysis of financial condition, results of operations and cash flows for the third quarter and nine months ended 31 December 2006*, p. 42.

constraint on the pricing of those calls. From an end-user's perspective, there is little to no difference between making a call to a mobile from a fixed-line or from a mobile phone. This is particularly so in the Exemption Area, where strong mobile reception is pervasive. Accordingly, the decision as to which device to use is largely a function of price and convenience.

This view is consistent with that previously espoused by industry analysts and other industry participants including Optus, the Competitive Carriers Coalition and Vodafone. One industry analyst has observed that *"empirical evidence suggests the Australian market is at the cusp of wholesale migration of voice traffic to mobile services"*.³⁹ Vodafone has stated that it is *"actively encouraging customers to substitute fixed calls with mobile calls with a number of customer offerings"* and the recognition *"that there is competition between M2M and F2M is in fact acknowledging that mobile services are part of a broader telephony market"*.⁴⁰ Vodafone has elsewhere acknowledged that:⁴¹

"For some people, mobile phones have now become a real alternative to the fixed line. Over time, we believe that fixed to mobile substitution will continue, particularly for voice services."

Similarly, in the Commission's *Assessment of Vodafone's mobile terminating access service (MTAS) Undertaking: Final Decision*, (March 2006) ("**Vodafone MTAS Undertaking Decision**"), it was recognised *"that fixed-to-mobile substitution is starting to become a more common feature of the telecommunications sector more broadly."*⁴² This is consistent with the view of the Commission's expert consultant, WIK, who observed a gradually increasing trend to substitute fixed access lines for mobile subscriptions, with a number of telephone users giving up their fixed-line subscription and becoming mobile-only users.⁴³ Irrespective of whether an end-user abandons their fixed line in favour of becoming a mobile only user, at the level of any individual calling decision a mobile call now increasingly represents a substitute to a fixed line call.

Given the growing trend in substituting mobile calls for fixed-line calls, Telstra submits that mobile networks will inevitably and increasingly provide a constraint on the price of fixed voice services.

³⁹ Report from Citigroup (11 October 2004) quoted in ACCC Price Control Review (2005), p. 20.

⁴⁰ Vodafone letter to ACCC dated 9 October 2003, p. 6.

⁴¹ Vodafone, *Submission to the Australian Competition and Consumer Commission: Mobile Services Review 2003 Discussion Paper*, (13 June 2003), paras 3.22 and 3.65.

⁴² Vodafone MTAS Undertaking Decision, p. 84.

⁴³ WIK Report, p. 48.

The key competitive driver is low barriers to entry for DSLAM-based infrastructure

Barriers to entry are an important consideration for the purposes of section 152AB(2)(c) of the Act, as low barriers to entry indicate that market conditions are conducive to competition.⁴⁴ Barriers to entry and expansion in the Exemption Area are low primarily because of potential new entrants can utilise DSLAM-based infrastructure to compete with Telstra resale services. Where barriers to entry are low Telstra (and other market participants) are constrained to behave in a manner consistent with competitive market outcomes, and regulatory intervention is not in the LTIE as it only introduces superfluous costs (which will ultimately be passed on to end users).

The fact that there are not material barriers to competitor entry and expansion using DSLAM-based infrastructure is due to the following factors:

- entrants do not face materially higher sunk costs than Telstra in relation to investments in DSLAMs;
- entrants do not face materially higher minimum efficient scale (MES) barriers than Telstra in relation to investments in DSLAMs;
- there are no technical constraints to DSLAM-based competitors providing a standard telephone service (STS) of an equivalent quality to Telstra's STS;
- entrants do not face materially higher backhaul transmission costs than Telstra in relation to investment in DSLAMs; and
- non-price impediments to DSLAM-based entry and expansion do not pose material barriers to competitors.

These factors are each discussed in turn below.

The sunk costs associated with DSLAM-based entry are not a barrier to new entry

Sunk costs associated with DSLAM-based entry are not a material barrier to entry for the following reasons:

- a significant proportion of the costs involved in DSLAM investment are unlikely to be sunk. This is because DSLAMs are capable of redeployment by market participants

⁴⁴ This is not controversial. For an example of the broad economic case for the relationship between an absence of barriers to entry and a contestable, competitive market, see Janusz Ordoover, "Effective Telecommunications Service Competition in Australia and the Need for Regulatory Reform (26 November 2000), submission to the Productivity Commission at pp. 65-66. The importance of barriers to entry has also been recognised by the Commission in its *Merger Guidelines* (at p. 48).

(including Telstra's competitors) in the face of changing demand conditions. Further, DSLAMs have a relatively short life span any period longer than this life span, DSLAM expenses are not sunk costs by definition. Lastly, DSLAM costs form a relatively small component of a competitor's overall costs;⁴⁵

- switching and transmission infrastructure used to provide the voice component of a bundle of voice and broadband services could include sunk costs if it is self-provided. However, as DSLAM-based access seekers can purchase these services from existing network operators such as Optus, Primus, AAPT, Soul and Telstra, these sunk costs can be largely avoided;⁴⁶ and
- sunk advertising and marketing costs associated with DSLAM-based entry at the wholesale level are likely to be minimal as wholesalers can readily identify and directly approach their potential customers who must be licensed carriers. To the extent that DSLAM-based wholesale entrants consider advertising and marketing costs at the retail level (due to self-supply of wholesale services), it is unlikely there will be any additional sunk costs in moving from reliance on resale to use of DSLAMs to provide retail services.⁴⁷

The Minimum Efficient Scale required for DSLAM entry is not a barrier

A risk associated with DSLAM-based entry is the *ex ante* uncertainty as to whether an entrant will obtain the minimum efficient scale (“MES”) necessary to be competitive in the market.

However, any MES requirements associated with DSLAM-based entry are not a material barrier to entry for the following reasons:

- technological developments continue to lower any potential barriers to entry that may arise from MES requirements as DSLAMs become increasingly scalable over time; and
- the wholesale supply of local call services to carriage service providers should not be analysed in isolation from the supply of other services that make use of the same network infrastructure. Accordingly the MES should be considered in the context of bundled voice and data services such that MES need not be reached in the voice market alone in order for MES to not prove a significant barrier to entry. With the rapid growth of, and demand for, retail broadband services, Telstra submits that Telstra's competitors will not face prohibitive difficulties in reaching MES.

⁴⁵ Paterson Report, p. 37.

⁴⁶ Paterson Report, p. 38.

⁴⁷ Paterson Report, p. 38..

For the purpose of the Exemption Applications, economists within Telstra have undertaken MES-related modelling work which has been provided to Dr Paul Paterson for analysis. A summary of the modelling results is set out in Table 5 below.

[C-I-C]

As Table 5 indicates, at current retail prices, the minimum number of retail SIOs at which ULLS entry becomes viable is no more than [c-i-c] SIOs in Band 2 (where the Exemption Area ESAs are located). These thresholds would increase if there were retail price reductions resulting from increased competition (which would be expected if the Exemptions are granted).

However, according to Dr Paterson:⁴⁸

“... this would be of no concern if it was due to increased competition resulting in lower prices (this clearly being in the LTIE). In any case, the Band 2 SIO threshold at current prices identified by the model is very low and in my view affords substantial leeway for retail price reductions for voice services without raising MES concerns. In short, I conclude that MES issues are unlikely to prevent de novo ULLS entry at present (or lower) retail prices, especially for existing retailers currently using LCS/WLR who could be expected to already have significant customer numbers in Band 2 ESAs.”

The provision of a STS voice service is not a material barrier to entry

Telstra submits that there are no technical constraints which would prevent DSLAM-based competitors from providing a STS of equal quality to the STS provided by Telstra. Accordingly, this should allay any concerns that Telstra may be able to leverage any competitive advantage from being able to provide a superior quality STS in the wholesale market.⁴⁹

Backhaul costs are not a material barrier to entry

Backhaul costs associated with DSLAM-based entry do not constitute a material barrier to entry because the backhaul transmission market in the Band 2 ESAs to which the Exemption Applications relate is mature and new entrants are able to purchase backhaul transmission from a number of providers.

There are no non-price impediments which constitute a material barrier to entry

Finally, it might be argued that Telstra may be able to impede DSLAM-based competitors through non-price conduct, such as providing a lower quality service than that provided to itself or intentional delays in the provisions of the service.

⁴⁸ Paterson Report, p. 39.

⁴⁹ Paterson Report, p. 40.

This is not a valid barrier to DSLAM-based entry or expansion for the following reasons:⁵⁰

- a. Telstra would be constrained in engaging in any anti-competitive conduct by Part XIB of the Act;
- b. in respect of the quality and timely delivery of the ULLS or LSS, Telstra is constrained by the standard access obligations, in particular sub-section 152AR(3), which requires Telstra to take all reasonable steps to ensure that the quality of the service is equivalent to that which it provides itself; and
- c. in relation to network upgrades, Telstra has obligations under its Operational Separation Requirements to ensure that it has provided equivalent notice of network upgrades to its access seekers as it does to itself.⁵¹

⁵⁰ Paterson Report, p. 41.

⁵¹ See clauses 3.8 and 5.15 of the Operational Separation Plan Telstra provided pursuant to the *Telecommunications Act 1997* (Cth).

Continued regulation is unnecessary and potentially harmful

In this section, Telstra sets out the risks and costs faced in the event the Commission refuses to grant the Exemption Applications. Specifically, Telstra will clarify how continued unnecessary declaration of the LCS and WLR will distort the market and sets out evidence on the extent and drivers of competition in the markets for the LCS, WLR and related services in the Exemption Area.

All regulation is costly, and unnecessary regulation will impose costs that outweigh any perceived benefits. In a competitive environment, regulation that impacts on and interferes with the normal operation of the market is likely to inflict significant costs on society.

As the Commission itself recognised, continued regulation is unnecessary and costly where competition in a particular market is effective and is likely to remain so. This view was repeatedly stated in the 2002 Final Decision:⁵²

“A relevant consideration in determining whether the exemption will promote competition or encourage economically efficient use of and investment in infrastructure is whether the market is likely to function efficiently in the absence of the service declaration. Related to this is the principle that if the market works effectively without regulation, then regulation will impose unnecessary costs to the economy. Removal of regulation will therefore remove these costs, which in turn would be likely to promote competition and encourage efficient investment. Accordingly, if it is likely that the market would function efficiently without regulation, granting the exemption should promote the LTIE.

...

Where competition in a market for the supply of a service is effective, and is likely to remain so, continued declaration of the service in those markets is unlikely to be necessary to ensure services are supplied at a competitive price and of the requisite quality.

...

“Where existing market conditions already provide for the competitive supply of services, the access regime should not impose regulated access. This recognises the costs of providing access, such as administration and compliance, as well as potential disincentives to investment. Regulation will only be desirable where it leads to benefits in

⁵² 2002 Final Decision, p. 9, 10, 15-16.

terms of lower prices, better services or improved service quality for end-users that outweigh any costs of regulation.”

In the broader context of the Fixed Services Review, the Commission referred to the concept of “enduring bottlenecks”, which is defined to mean “a network element or facility that exhibits natural monopoly characteristics and is ‘essential’ to being able to provide services to end-users in downstream markets in a way that promotes the [LTIE]”.⁵³ In this regard, the Commission expressed the view (at p. iii) that:

“Where an enduring bottleneck does not persist, the Commission will be inclined to progressively withdraw ex ante regulation where it is confident that declaration is not required to promote the LTIE.

The Commission’s approach is based on the principle that where it is economically efficient, facilities-based competition is more likely to promote the LTIE. This is because this form of competition allows rivals to differentiate their services and compete more vigorously across greater elements of the supply chain.

It is also based on the principle that, for services or network elements which are not enduring bottlenecks, competitors that do not wish to invest in their own infrastructure will, more than likely, have the opportunity to enter into commercially negotiated arrangements for access with third parties (or the incumbent) without the need for ex ante regulatory intervention. In this regard, the withdrawal of access regulation at certain network layers does not necessarily suggest that these forms of competition will cease, or that their price will necessarily be raised excessively by the access provider. Rather, it is recognition that ex ante regulation is no longer required to ensure that these services are competitively priced at or near their underlying costs.”

It is clear that there is extensive alternative infrastructure within the Exemption Area, and that this is driving competition in the market for fixed line voice services (and related services). In particular, the emergence and deployment of DSLAM-based alternative infrastructure means that these markets are now workably competitive.

In this competitive environment, continuing to impose the severe ex ante regulatory regime that exists under Part XIC for the LCS and WLR services is unnecessary and costly. The end result will be a stifled and distorted market to the ultimate detriment of Australian telecommunication users.

⁵³ FSR - Second Position Paper, p. ii.

Regulation will never provide the same incentives for efficient investment in infrastructure as a workably competitive market because of the potential risks involved, which include:

- the inherent truncation of returns;
- potential for regulatory dependence;
- arbitrage; and
- asymmetric impacts.

The cumulative impact, of these adverse regulatory effects, is the inefficient (and typically under-) investment in infrastructure, which result in consumers not being offered the full range and quality of services they would expect in a competitive market.

Truncation of returns

In workably competitive markets the “upside” (i.e. above average returns) of successful investments compensates for the “downside” of unsuccessful projects, such that the overall expected return will be normal over the long term.

Regulated access prices tend to truncate the reward of a successful investment without reducing losses from unsuccessful investments, thereby reducing incentives for investment.

As Dr Paterson notes:

“...access-based competition can be severely detrimental to the level of investment where access provider investment incentives are reduced by the truncation of investment rewards from access price regulation. This truncation occurs as cost-based access pricing restricts an investor enjoying super-normal profits when a successful investment decision is made. This eliminates the scope to fund those investments that turn out to be loss-making, dampening the incentive for risk-taking.”⁵⁴

Granting the Exemptions will remove the potential for truncation of returns to reduce investment in infrastructure by the access provider without adversely impacting on the access seeker. In a market as dynamic as telecommunications, the long run benefits to end-users this will bring outweigh any perceived short-run benefits from artificially lower prices due to unnecessary regulated access.

Potential for regulatory dependence

By contrast, continuing to regulate the provision of LCS and WLR in the Exemption Area would provide a crutch to passive competitors unwilling or unable to invest in infrastructure

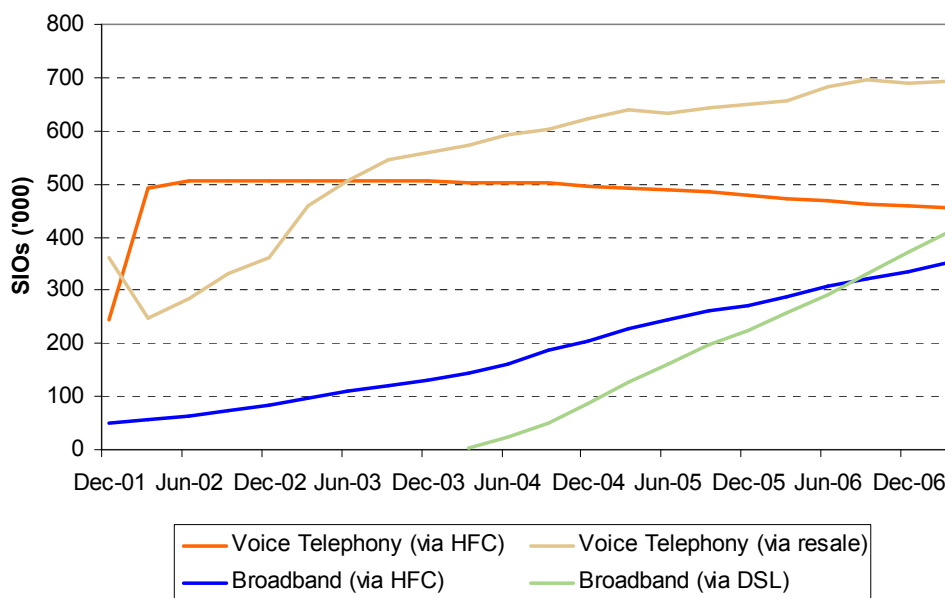
⁵⁴ Paterson Report, p. 56.

and to commit to the rigours of a competitive market. Continuing regulation of services in workably competitive markets harms the consumer by delaying progression to facilities-based competition.

Based on Dr Paterson’s analysis, it appears that regulatory dependence is clearly prevalent in the market in which fixed voice services are supplied, as evidenced by the high volume of pure resale, despite the availability of substitutes, such as ULLS and VoIP in the metropolitan areas.⁵⁵

The regulatory dependence that can be caused by unnecessary resale regulation is perhaps most striking in the case of Optus’ experience as demonstrated in Figure 8, which shows a negative growth in the number of telephony SIOs on Optus’ HFC network while simultaneously depicting a dramatic growth in its acquisition of the LCS and WLR.

Figure 8: Demand for Optus’ Voice and Broadband Services, by platform, March 2002 to March 2007



Source: Paterson Report, Figure 11, p. 58 .

Arbitrage

In a competitive market, prices adjust to eliminate arbitrage opportunities; however, arbitrage opportunities may persist in a regulated market because price relativities do not adjust to equal those that would be observed in a competitive market. In this context, Dr Paterson observes that:

⁵⁵ Paterson Report p. 58.

“Where access prices are set by regulators, and especially where prices are set for a number of access services that are close substitutes, the relativities of those prices determine their relative attractiveness. Where those relativities do not mirror those that would occur in an efficient, competitive market, inefficient arbitrage opportunities are created and maintained by regulation – some services are over-used and others are under-used relative to an efficient outcome.”⁵⁶

The Commission itself has recognised this problem as follows:

“Competitors’ decisions about the basis on which to compete will, in large part, depend on access prices relative to investment cost. So long as these signals are correct, the market should make appropriate decisions about whether to invest in alternative infrastructure, and/or rely on Telstra’s network and the extent of this reliance. If access prices do not reflect efficient costs, or there are market failures or uncertainty, then competitors’ decisions about whether to build or buy could be distorted.”⁵⁷

Put simply, regulated resale competition provides access prices that are “prone to error” (in the sense that they do not provide efficient build/buy signals) and thus create arbitrage opportunities. The distortions created by inefficient regulatory build/buy signals have been recently identified by the Canadian Telecommunications Policy Review Panel:

“One argument advanced in favour of a very broad scope of mandated access is that such an approach would promote all forms of competition by making it easier for competitors to resell any portion of the ILEC’s network that they want. However, in the Panel’s view, a broader scope makes the distortion of entry and investment decisions more pervasive. For this reason, a broad scope of mandated access would not in fact promote all forms of competition. Rather, it would promote only one form of entry (i.e. resale), thus perpetuating disincentives for new entrants to build facilities and entrenching the ILECs’ SMP [substantial market power] over the network and its elements.”⁵⁸

These distortions provide a persuasive example of why the Commission should adopt a proactive role in reducing the extent of access regulation, particularly the regulation of resale services. Therefore although regulated access promotes arbitrage, it does little to encourage facilities based competition. In this context, granting the Exemptions would provide appropriate incentives to competitors to develop competing networks.

⁵⁶ Paterson Report p. 56.

⁵⁷ 2006 Strategic Review, p. 13.

⁵⁸ Canadian Telecommunications Policy Review Panel, *Final Report* ((March 2006), pp 3-35, available at: [http://www.telecomreview.ca/epic/internet/intprp-gecrt.nsf/vwapj/report_e.pdf/\\$FILE/report_e.pdf](http://www.telecomreview.ca/epic/internet/intprp-gecrt.nsf/vwapj/report_e.pdf/$FILE/report_e.pdf) (accessed 29 November 2006).

Asymmetric impacts

A key problem faced in setting regulated prices is the amount and quality of information required to make good regulatory decisions. Imperfect information will lead to regulatory errors being made. The errors can be particularly costly in a regulated access setting where an inefficient pricing structure, chosen by the regulator, will result in prices that distort production and consumption decisions and investment decisions.

It is arguable that the likelihood of regulatory error is asymmetrical — that is that the regulatory structure and incentives faced by the regulator are more likely to lead to prices being lower than the efficient level, rather than being higher than the efficient level. However, even if the risk of over-pricing is equal to that of under-pricing, the resulting impact will not be symmetrical. As noted by Dr Paterson:

“While over-pricing access by the regulator is unlikely to result in inefficient over-investment (as the access provider can price below the regulated price to avoid damaging by-pass investment by access seekers), under-pricing will tend to cause under-investment by both access seekers and the incumbent. Specifically, access seekers will have an incentive to use the incumbent’s network to an inefficient extent rather than build themselves, while the incumbent will be reluctant to invest up to an efficient level as its returns are diminished by the below-cost access price.”⁵⁹

These unnecessary regulatory impacts will result in inefficient levels of investment

As demonstrated above regulation is costly and when unnecessarily imposed on competitive markets it will inefficiently distort investment incentives by imposing two classes of costs:

- regulation per se, even if perfectly executed, imposes transaction, compliance and administrative costs;⁶⁰ and
- even with the best intent and most skilful execution possible, there is inevitably an element of regulatory error which itself imposes costs.⁶¹

This in turn implies that where a market is workably competitive (as is the case for the LCS and WLR within the Exemption Area) then continued declaration will impede efficient investment in infrastructure.

⁵⁹ Paterson Report, p. 57.

⁶⁰ Paterson Report, p. 60.

⁶¹ Paterson Report, p. 60.

Indeed, as submitted above, continued declaration in the Exemption Area will positively frustrate efficient use of and investment in infrastructure by both the access provider and by access seekers.

Ongoing declaration has reduced the incentives for efficient investment in infrastructure in the fixed-telecommunications market. In this context, any reduction in incentives to invest, if not sufficiently justified on antitrust grounds should be prima facie indication that regulation is 'doing more harm than good' and exemption is appropriate.

4 Granting the Exemptions will promote the LTIE

The factors set out in this submission establish that, from an economic perspective and from an assessment of the state of competition, there is no reasonable basis for the Commission to continue regulating the LCS and WLR in the Exemption Area. In this section, Telstra applies these factors to each limb of the LTIE test and concludes that, upon a proper consideration of that test (as interpreted by the Tribunal), the Commission must reach the conclusion that granting the Exemptions has the overall effect of promoting the LTIE.

Promotion of competition

Based on the Commission's own rationale, continued regulation is both unnecessary and costly where it can be shown that the market in which the relevant service is supplied is already competitive and is likely to remain competitive. This is particularly the case where regulation will hinder the development of facilities-based competition, which is a more efficient promoter of competition.

In its 2006 Draft Decision, for example, the Commission quoted from Commissioner Ed Willett's speech given at the AFR Fourth National Infrastructure Summit, where the Commissioner stated that the most competitive and innovative areas are those in which competitors have built their own networks, rather than just reselling space on Telstra lines.⁶² More recently, the Commission expressed this view in its recent FSR - Second Position Paper, stating:

*"The Commission's approach is based on the principle that where it is economically efficient, facilities-based competition is more likely to promote the LTIE. This is because this form of competition allows rivals to differentiate their services and compete more vigorously across the greater elements of the supply chain."*⁶³

This sentiment is echoed by commentators such as Cave, who points out that, given the choice between regulation and competition – competition wins:

*Almost everyone believes that 'competition is the best regulator'. It promotes consumer welfare by offering choice, variety, keen prices and innovation; whereas regulation is often associated (but is not necessarily the sole cause of) lack of choice, uniformity, high costs and disincentives to innovate.*⁶⁴

⁶² Willett, E, Commissioner, speaking at the AFR Fourth National Infrastructure Summit, Sydney, August 2005.

⁶³ FSR - Second Position Paper, p iii.

⁶⁴ Cave, *Making the ladder of investment operational* 2004.

Facilities-based competition is preferable to regulated access for a number of reasons. First, it can lead to greater price competition as entrants have more control over costs and face incentives to develop and deploy more efficient technologies in order to compete with the incumbent operators.⁶⁵ This would in turn lead to greater product differentiation, delivering lower prices and greater choices to consumers.

Second, it enables greater service innovation since the entrants are no longer tied to the functionality of the incumbent's network.⁶⁶

Third, it also ensures that competition for supply will extend over a wide-range of markets, driving out inefficiency and arbitrage throughout the supply chain, and delivers superior results to the limited form of resale competition that regulation promotes.

By contrast, for the reasons identified in section 4, access or resale based regulation can reduce the intensity of competition by dampening the firms' incentives to compete across the value chain, and by reducing the scope for product differentiation. It also promotes similarity in cost structures and service offerings such that end-users are unlikely to benefit from real service diversity and have little prospect of realising gains from innovation.

The importance of service element diversity was recognised by the Commission in the 2002 Final Decision as follows:

“Where, for example, an exemption is likely to result in increased service diversity, end-users will be able to gain access to an increased range or choice of services. In such a case, an exemption may be expected to promote competition to a greater extent than continuing declaration that results in a larger number of suppliers in the market, but means all suppliers essentially offer the same service at the same price.”⁶⁷

The stepping stone model

One argument in favour of temporary regulated access has been the “stepping-stone” model (also known as the “ladder of investment”), which the Commission has endorsed as providing the analytical basis for declaration. However, the stepping stone model has now been called into question, both in Australia and overseas, particularly in circumstances where it appears

⁶⁵ Duarte Brito and Pedro Pereira (2005), “Ownership Structure of Cable Networks and Competition in Local Access,” *mimeo*, April.

⁶⁶ Cave M, ‘Encouraging infrastructure competition via the ladder of investment, *Telecommunications Policy*, 30, 223-237, 2006.

⁶⁷ 2002 Final Decision at page 17.

to be impeding the development of facilities-based competition.⁶⁸ For example, in the FSR – Second Position Paper the Commission states:

“In its June 2006 position paper, the Commission supported the ‘stepping stone’ approach to competition, but with the very important caveat that ‘full facilities-based competition is the end goal in all circumstances’. Further, the Commission notes that the stepping stone hypothesis does not necessarily suggest that multiple forms of mandated access at different network layers should be left in place indefinitely. The Commission’s position has consistently been that it will only seek to promote facilities based (full or quasi) competition where it is likely to be economically efficient, and therefore in the LTIE.”

...

“...it increasingly appears that the seamless continuum that is implied under the stepping stone hypothesis – between resale-based competition and full facilities-based competition – is unlikely to be a realistic outcome for the regulation of fixed line services. Moreover, it appears increasingly likely that the presence of enduring bottlenecks in fixed-line markets is likely to differ in nature across different geographic regions in Australia.”⁶⁹

Telstra has previously criticised the validity of the stepping stone model as a basis for setting regulatory policy in Australia and repeats those concerns here.⁷⁰ Accordingly, Telstra welcomes the Commission’s willingness to reconsider the usefulness of this model, including in areas where alternative infrastructure based competition exists.

Irrespective, of whether or not the stepping stone or ladder of investment hypothesis is valid, it was never intended that it would operate as a permanent and sweeping fixture across the entire telecommunications landscape. As one of the original proponents of the ladder of investment hypothesis Martin Cave, said:

“[the regulator should choose] the point on the ladder at which the intervention should still be applied. This decision will be based on an analysis of the scale and prospects of the operators at various points, with a bias in favour of those more advanced in their infrastructure buildings.”⁷¹

⁶⁸ See for example, Appendix to "Restoring European economic and social progress: unleashing the potential of ICT", a report by Indepen for the Brussels Round Table of leading European telecommunications operators and equipment Manufacturers: Brian Williamson, Phillipa Marks, David Lewin, Justine Bond and Helen Lay.

⁶⁹ FSR - Second Position Paper, p. 21.

⁷⁰ See, for example, pages 15-17 of Telstra’s response to the Commission Proposal – “A Strategic Review of the regulation of fixed network services”, February 2006.

⁷¹ Martin Cave. November 2004. *Making the ladder of investment operational*,. p 29.

Cave argues that this step is necessary to avoid the very real risk that application of the ladder of investment approach will slow down rather than speed up investment:

“[the ladder of investment] is not an argument for providing access at low prices on a carte blanche basis. Instead the proper approach seeks to restrict mandatory access to a limited period – after which it ceases to be available, or becomes subject to commercial agreement, or rises in the regulated price.”⁷²

Cave argues further that as far as possible where assets are found to be non-replicable a single rung on the ladder is proposed in terms of access and regulation, and can be withdrawn where an asset is already or imminently replicable. As Cave says, a “...*rigorous approach is necessary to prevent implementation of the ‘ladder’ approach relapsing into a policy of ‘easy access’, thereby **denying consumers the benefits of infrastructure competition***”⁷³ (emphasis added).

The surest step towards facilities-based competition is not continued declaration, but rather exemption in those areas where there is actual infrastructure roll-out. This will, in turn, send the correct signals to the market that regulation, at the very least regulation of resale services where enduring bottlenecks do not exist, is not intended to be a permanent fixture on the telecommunications landscape and will be removed at the earliest opportunity where facilities-based or quasi-facilities-based alternatives exist.

The Exemptions will promote facilities-based competition

The Exemptions will promote facilities-based competition (and therefore satisfy the promotion of competition criterion) in the market in which the LCS and WLR are supplied for the following reasons.

First, there is extensive roll-out of alternative infrastructure in the Exemption Area (in particular DSLAM-based infrastructure and to a lesser extent HFC networks) which can be used as alternatives to the LCS and WLR in providing downstream services.

Second, empirical and economic evidence (set out in sections 2 and 3) illustrate that efficient, workable competition already exists in the markets in which the LCS and WLR are provided because of the presence of these alternatives.

Third, the extent of competition is only likely to improve further in the future given that the barriers to entry and expansion to these alternatives are low, and with the increasing penetration of new technologies such as VoIP.

⁷² As above, at p. 29.

⁷³ As above, at p. 30

Given that the market in which the LCS and WLR are supplied is already workably competitive and is likely to remain so, the Exemptions will ensure that competitors will rely less on regulated prices in the Exemption Area and will face greater incentives to develop more efficient technologies to compete with incumbent operators. This will facilitate a movement away from access-based competition towards facilities-based competition, which will in turn drive out inefficiency and arbitrage throughout the supply chains, delivering lower prices and greater choice to consumers in the long-run.

The Exemptions will not compromise competition

Further, for the reasons set out below, granting the Exemptions will not foreclose or compromise competition in the downstream markets because of supply side substitution in the upstream input market.

One potential concern associated with the granting of any exemption order might be that Telstra would attempt to take advantage of perceived absence of regulatory control and raise prices above cost in a manner it could not do if the services continued to be declared, or that it would withdraw the services altogether.

However, the existence of workable competition in the Exemption Area, based on the ready availability of alternative upstream inputs, means that any rise in Telstra's LCS/WLR price above its efficient costs, would not materially affect competition in the retail market and prices would continue to be competed down in those areas towards efficient costs.

Likewise, due to the competitive constraints imposed on each ESA (in particular by the presence of DSLAM-based entry) Telstra will have incentive to continue to supply LCS and WLR to maximise utilisation of its own network assets as it is faced with intense competition in supplying competitive voice services to end-users in those areas.⁷⁴

All of this, of course, ignores the reality that the price Telstra charges for LCS and WLR is likewise competitively constrained. Any attempt to price these services above the competitive level would be quickly responded to by increased DSLAM roll-out and extension of existing capacity, increased self-supply of services and expansion of wholesaling by alternative infrastructure providers (including DSLAM based-competitors). This would lead to the "supra-competitive" price increase being competed out and pricing would then revert to competitive levels. Significantly, this would be achieved without regulatory intervention, without the risk of regulatory error, distortion and overreach and without regulatory delay, reflecting the supremacy of workable competition as the best regulator. This state of play

⁷⁴ For example, the presence of other resellers or wholesalers of voice, line rental and related services means that at both the wholesale and retail layer Telstra will face significant competition in the drive to retain and attract end-customers to its network.

exists now in the Exemption Area and the intrusion of regulation is unnecessary and damaging.⁷⁵ It is nonsensical to posit that the Exemptions might be granted (which would require a finding that Telstra is constrained by workable competition in the Exemption Area) and then to hypothesize about whether Telstra could act without competitive constraint after the Exemptions are granted.

It is important to note that Telstra has never refused to supply either of the LCS or WLR services irrespective of whether these services have been declared. For LCS, since CBD areas were exempted from 2003, Telstra has continued to supply these services and the prices of these services has not increased compared to the price charged in other areas. WLR itself has only been declared for 12 months but its declaration was not prompted by any refusal to supply the service by Telstra. The key point is that Telstra has no incentive to either withdraw supply or price in a way which would negatively impact its resale customers. To do either of these things in the Exemption Area would only accelerate the bypass of Telstra's network we are already observing in these areas.

A further concern is that the granting of the Exemptions might foreclose or compromise competition in the downstream market. However, Telstra submits that this concern is unfounded. As noted, substitution possibilities are ubiquitous in the Exemption Area as each ESA has at least one (and in many cases more) DSLAM(s) installed. If Telstra were to indulge in profit maximisation or foreclosure strategies, the ready availability of upstream inputs, notably ULLS, in the Exemption Areas would allow retailers to simply substitute away from Telstra supplied LCS/WLR. As noted by Dr Paterson, supply side substitution in the upstream input market effectively negates Telstra's ability to foreclose competitors in the downstream retail market.⁷⁶

Nor will the exemptions compromise downstream competition by reducing the ability and/or incentive for current resellers to compete for and supply customers' standalone voice services. As concluded by Dr Paterson, the Exemptions are unlikely to have any material effect in competition in respect of the voice-only customer segment for two reasons: first, in the Exemption Area, Telstra will be constrained by at least one other service provider with the technology base to provide resellers with a wholesale voice-only service; second, existing DSLAM-based operators can viably supply voice-only services to the majority of this customer segment.⁷⁷

⁷⁵ Refer more detailed discussion of the risks and damage caused by regulatory over-reach and damage in section 4 above.

⁷⁶ Paterson Report , p. 49.

⁷⁷ Paterson Report p. 51.

Finally, Telstra notes that Part XIB of the Act provides an additional layer of protection against concerns that the Exemption could result in foreclosure of the retail fixed-calls market.

Any-to-any connectivity of end-users

Telstra submits that, given the extent of available alternative infrastructure and declared services which provide or are readily capable of providing similar services to the LCS and WLR, the granting of the Exemptions will not affect the any-to-any connectivity of end-users.

Indeed, when the Commission approved Telstra's application for exemption from the standard access obligations in respect of the LCS in CBD areas, it noted that the any-to-any criterion enabled the consideration of "similar" services to the service in question:⁷⁸

"The reference to 'similar' services in the Act enables this objective to apply to services with analogous, but not identical, functional characteristics, such as fixed and mobile voice telephony services or Internet services which may have differing characteristics."

Accordingly, the Commission concluded in the 2002 Final Decision that:⁷⁹

"The Commission is satisfied that with the presence of alternative infrastructure and declared services, the exemption will not have bearing on any-to-any connectivity."

Telstra agrees with this assessment and submits that it is also applicable to the current Exemption Applications.

Efficient use of and investment in infrastructure

As noted above, granting the Exemptions will promote facilities-based competition through encouraging greater investment in competing infrastructure. Telstra further submits that granting the Exemptions will promote the efficient use of, and investment in, infrastructure and makes the following observations in respect of each of the factors of consideration under this limb of the LTIE:

- ***technical feasibility*** - the widespread deployment of DSLAMs, and consequently, the supply (and self-supply) of services equivalent to the LCS and WLR over DSLAM infrastructure in the Exemption Area demonstrates that alternative means of supply are technically feasible within the Exemption Area;

⁷⁸ 2006 Final Decision, p. 58.

⁷⁹ 2006 Final Decision, p. 58.

- ***legitimate interests of the access provider*** - Telstra's legitimate business interests will not be adversely affected by the granting of the Exemptions, but rather will be enhanced by allowing Telstra greater commercial freedom and flexibility; and
- ***incentives for investment*** - as set out above, the incentives for investment will be greatly improved if the Exemptions are granted because the risks and potential market distortions associated with investment in a regulated environment will be removed.

Overall net effect of Exemptions is in the LTIE

Lastly, Telstra notes that it is important to keep in mind in considering the Exemption Applications that the statutory criteria and the case law demand that the Commission consider the overall net effect of the Exemptions. Therefore, even if the Commission is of the view that the Exemptions would bring about some temporary or transient deficiencies in competition or is not perfectly satisfied with some of Telstra's arguments, Telstra submits that the overwhelming long-term benefits of the Exemptions through promoting facilities-based competition and removing unwarranted regulation would significantly outweigh any such short-term negative impacts.

Granting the Exemptions will create a more responsive, competitive telecommunications environment within the Exemption Area. Removing unnecessary access regulation in areas where there is already workable facilities-based competition will further promote competition in the supply of fixed voice and broadband services. Granting the Exemptions will also encourage firms (including Telstra) to invest in infrastructure, enabling the provision of a greater variety of services. This will create an environment that will result in real improvements to the interests of Australian telecommunications users over the long term.

Telstra Corporation Limited

9 July 2007

APPENDIX 1 - Statutory criteria and market definition

This Annexure sets out the legal analysis underlying Telstra’s view of the statutory criteria and the relevance of market definition for the purposes of the Exemptions.

Statutory criteria

Part XIC of the Act establishes an industry specific regime for regulated access to telecommunications services designed to promote the LTIE of carriage services or services provided by means of carriage services. The Commission is required to grant the Exemption Applications pursuant to section 152AT of the Act if doing so will promote the LTIE.

As is well known, in determining whether a particular thing promotes the LTIE, regard must be had to the following objectives set out in section 152AB of the Act:

- (a) the objective of promoting competition in markets for carriage services and services supplied by means of carriage services;
- (b) the objective of achieving any-to-any connectivity for carriage services involving communication between end-users; and
- (c) the objective of encouraging the economically efficient use of, and economically efficient investment in, the infrastructure by which carriage services and services provided by means of carriage services are supplied.

Section 152AB(6) of the Act provides that in determining whether exemption is likely to result in the achievement of the objective of encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which listed services are supplied regard must be had to:

- the technical feasibility of supplying the service;
- the legitimate commercial interests of the supplier of the services; and
- the incentives for investment in the infrastructure by which the service are supplied and any other infrastructure by which services are, or are likely to become, capable of being supplied.

For present purposes, the “particular things” are the making of orders exempting Telstra from all of the standard access obligations in respect of the supply of the LCS and the WLR in the

Exemption Area. Accordingly the relevant question is whether the Exemptions will meet the objectives set out above.⁸⁰

The phrase “regard must be had” means that the decision maker is required to take those objectives into account and to give weight to them as fundamental elements in making its determination.⁸¹ It is difficult to conceive that it could have been intended that the decision maker might decide to give no weight at all to one or more of these objectives.⁸²

The approach to interpreting and applying the LTIE test has been articulated by the Tribunal in its 2004 Foxtel decision on the applications for anticipatory exemptions lodged by Telstra and Foxtel in respect of the analogue pay TV service.⁸³ This approach, which Telstra respectfully adopts, is summarised in the following paragraphs from that decision:

“108 *The point is ... whether there are other (favourable) consequences of exemption such that the abrogation or withdrawal of the protection provided by the standard access obligations, by way of exemption from those obligations can be justified.*

109 *The focus of the Commission and the Tribunal must be upon the fact that it is the exemption from the standard access obligations that will promote the long-term interests of end-users. This is made clear by the provisions of s 152AB of the Act, particularly in subs (2). It is made clear that it is a “particular thing” that is to promote the long-term interests of end-users. In the particular cases before the Tribunal, the “particular thing” is the making of an order exempting the carrier or carriage service provider from all the standard access obligations. Accordingly, it is necessary to ask whether the exemption from those obligations will achieve the objectives set out in subs (2) of s 152AB.*

119 *We accept that the ‘future with and without’ approach provides helpful guidance in applying the LTIE test. In making this assessment we are guided by the fact that, in the words of s 152AB(2), the “particular thing” that is before us is the granting of the exemption applications... . However, it should be noted that the ‘future with and without’ test requires the forecasting of future market behaviour, competitive activity and market conduct in a particular area or region and the development of an investment. But the answer to the*

⁸⁰ *Seven Network Limited (No.4)* [2004] ACompT 11 at [109].

⁸¹ *R v Hunt, ex Parte Sean Investments Pty Ltd*, (1979) 180 CLR 322 per Mason J at 329; *Telstra Corporation Limited*, Australian Competition Tribunal [2006] ACompT 4, at [68].

⁸² See *Re Michael, ex parte Epic Energy* [2002] WASCA 231 at [55].

⁸³ *Seven Network Limited (No.4)* [2004] ACompT 11.

application of that two-fold enquiry (the future with and without the exemption) is not the ultimate or final answer to the issues posed. That answer must be couched in terms of an appropriate degree of satisfaction that the making of an order exempting each of Foxtel and Telstra from the standard access obligations in s 152AR will promote the long-term interests of end-users of the services they provide. This degree of satisfaction is reached by applying the future with and the future without test, that is to say we compare the future situation with the exemption orders having been made with the future situation without the exemption orders having been made. We then ask the question: which situation is in the LTIE; cf Re QIW Ltd (1995) 132 ALR 225 at 276.

120 *Having regard to the legislation, as well as the guidance provided by the Explanatory Memorandum, it is necessary, in our view, to take the following matters into account when applying the touchstone – the long-term interests of end-users:*

- **End-users:** *in this matter, “end-users” include actual and potential subscribers to subscription television services and other viewers in their households. The term is also likely to include businesses, such as hotels and other places where people congregate, that subscribe or may potentially subscribe to subscription television services;*
- **Interests:** *the interests of end-users lie in obtaining lower prices (than would otherwise be the case), increased quality of service and increased diversity and scope in product offerings. In our view, this would include access to innovations such as interactivity in a quicker timeframe than would otherwise be the case; and*
- **Long-term:** *the long-term will be the period over which the full effects of the Tribunal’s decision will be felt. This means some years, being sufficient time for all players (being existing and potential competitors at the various functional stages of the subscription television industry) to adjust to the outcome, make investment decisions and implement growth – as well as entry and/or exit – strategies.*

122 *The use of the “long-term” may also assist in resolving the apparent tension between the criteria in s 152AB(2)(c) and (e). For example, action that promotes competition in the short-term may deter*

investment and hence, over the longer-term, competition may lessen (resulting in reductions to efficiency and innovation). Moreover, an action may promote competition at the retail level (resulting in more channels offered by more operators), but may deter facilities-based competition, with fewer service providers being prepared to establish delivery mechanisms of their own than would otherwise be the case. Assessed over the long-term, however, there is less likely to be any conflict between the promotion of competition and efficiency. Nonetheless, to the extent that there are mixed effects, we will have regard to the overall or net effect.

123 *It was put to us that the earlier decision in Re Sydney Airports Corporation Ltd (2000) 156 FLR 10 (“Sydney Airports”) provided assistance in interpreting the “promotion of competition” criterion. In Sydney Airports, a review of a decision to declare a facility pursuant to Pt IIIA of the Act, it was stated (at par [106]):*

“The Tribunal does not consider that the notion of ‘promoting’ competition in s44H(4)(a) requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased. Rather, the Tribunal considers that the notion of ‘promoting’ competition in s44H(4)(a) involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.” (paragraph 123)

124 *In our view, this description is apt for the criterion established under s 152ATA(6) and s 152AB(2)(c). In addition, we consider that this description is equally applicable to assessing whether the “particular thing” encourages economically efficient use of, and investment in, infrastructure pursuant to s 152AB(2)(e).”*

In light of this decision, the key question to be considered by the decision maker in each of the present cases is whether the granting of the Exemption will further each of the objectives that make up the LTIE. As enunciated by the Tribunal in the Foxtel decision, the starting point for making this assessment is to utilise the “future with and without” test and compare forecasted future market behaviour, competitive activity and market conduct if the

exemption is granted to future market behaviour, competitive activity and market conduct if the exemption is not granted.⁸⁴ Any such assessment must also take a sufficiently long term view to enable it take into account the full effects of the decision.

However, it should be noted that while the “future with and without” test may provide “helpful guidance” in applying the LTIE test, it should not and cannot be used to provide the ultimate or final answer to the issues in considering whether to exempt the LCS and the WLR. The danger of sole reliance on the “future with or without” test is that it can inadvertently lead to an analysis which does not consider all of the elements of the LTIE criterion, and would be contrary to the Tribunal’s expressed view in the Foxtel decision, where it clearly stated that the outcome of the test “is not the ultimate or final answer to the issues posed”.⁸⁵

These principles as enunciated in Tribunal decisions clearly establish that it is not an answer to an exemption application to identify:

- short-term (or even medium-term) or transitory detrimental consequences for competition where it is more likely than not that exemption would create the conditions or an environment that will result in an overall or net increase in the LTIE over the *long-term*; or
- “cherry-pick” isolated detrimental impacts (even over the long-term) where it is more likely than not that exemption would create the conditions or an environment that will result in an *overall or net increase* in the LTIE over the long-term.

Relevance of market definition to Exemption Applications

Section 4E of the Act defines “market” for the purposes of the Act. The Tribunal articulated this basic concept in *Re Queensland Co-Operative Milling Association Limited* (1976) ATPR ¶40-012 in the following terms (at 17,247):⁸⁶

“We take the concept of a market to be basically a very simple idea. A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them. (If there is no close competition there is of course a monopolistic market). Within the bounds of a market there is substitution — substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions

⁸⁴ See Foxtel decision at [119].

⁸⁵ Foxtel decision at [119].

⁸⁶ See also *Re Tooth & Co Ltd; Re Tooheys Ltd* (1979) ATPR ¶40-113 at 18,196-18,197 which further stressed the multi-dimensional aspect of markets and the way in which this should be considered.

between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive.”

In defining the relevant market, a purposive approach must be adopted.⁸⁷ That is, the market should not be defined in a vacuum and consideration needs to be given to the purpose for which the market definition exercise is being undertaken. This involves “a choice of the relevant range of activity by reference to economic and commercial realities and the policy of the statute” as a result of which “the identification will be evaluative and purposive as well as descriptive.”⁸⁸

In the present case, the purpose of the inquiry is the assessment of whether the granting of the Exemptions from the standard access obligations in respect of the LCS and the WLR would be in the LTIE. In this context, the focus is on the impact of the continued regulation of the LCS and the WLR on competition in a range of related downstream markets, the efficient operation of those markets, and the incentives for efficient investment in the infrastructure used to provide services in those markets.

In light of this purposive approach, it is important to analyse the LTIE implications of the continued declaration of the LCS and the WLR in the Exemption Area in its broader context - namely, that the LCS and the WLR are merely two of a number of services, including broadband data services, long distance and international calling services, and fixed-to-mobile calling services that can be provided at the wholesale and retail levels of these markets over DSL enabled lines. The declaration of the LCS and the WLR as distinct declared services under Part XIC should not be allowed to obscure the fact that granting the Exemptions will promote competition not only in the voice (including data over broadband) but also broadband (including voice over broadband) services markets.

This view is consistent with the analysis of the relevant retail markets conducted by Dr Paul Paterson, who concluded that:⁸⁹

*“the **relevant retail market includes the full bundle of fixed voice services**, those being basic access, local calls, national and international long distance calls and fixed to mobile calls. **The market potentially also includes broadband services.**”*
(emphasis added)

⁸⁷ This aspect has been reiterated in many decisions, see, for example, *Singapore Airlines Ltd v Taprobane Tours WA Pty Ltd* (1991) 33 FCR 158 at 174; and *Telecom Corporation of New Zealand Limited v Commerce Commission* (1991) 3 NZBLC 102, 360.

⁸⁸ *Singapore Airlines Ltd v Taprobane Tours WA Pty Ltd* (1991) 33 FCR 158 at 174.

⁸⁹ Paterson Report, p. 13.

Product market

Telstra agrees with the Commission that, in the case of the LCS, the relevant service for consideration is the wholesale supply of local call services to carriage service providers by Telstra. The position is similar in the case of the WLR, in that the relevant service for consideration is the wholesale supply of line rental services to carriage service providers by Telstra.

However, for the reasons set out above, Telstra submits that this does not mean that, for the purposes of Part XIC, the supply of these services should be analysed in isolation from each other, or the supply of other services that make use of the same network infrastructure.

For the reasons set out in the Overview, there are good reasons for considering the LCS and the WLR together as services provided in the same product market. It is uncontroversial that these two services are ordinarily offered to customers in the retail market as a bundle and that access seekers always acquire the services together. Further, the economic arguments supporting the exemption for LCS apply equally to the exemption for WLR. Indeed, the Commission recognised the close interaction between the LCS and WLR when it decided to continue the declaration of the LCS and declare the WLR (both for a period of 3 years) simultaneously in July 2006.⁹⁰

For the purpose of delineating the boundaries of the markets in which the LCS and WLR are provided, however, it is necessary to consider the other services which are also provided on the same network infrastructure. There is demand in Australia to acquire services which provide access to, or use of, fixed telephony networks for the purpose of supplying telecommunications services including fixed line rental services, local call services, long distance call services, international call services, fixed-to-mobile call services, dial-up internet access and data services, broadband and ADSL internet access and data services, and other data services (together “**Fixed Network Services**”) to suppliers of telecommunications services or to end-users.

Telstra submits that the WLR is supplied and acquired in a market for services which provide access to, or use of, fixed telephony networks for the purpose of supplying telecommunications services, including Fixed Network Services, to suppliers of telecommunications services or to end-users (“**Wholesale Fixed Network Services Market**”).

As retail fixed line rental services are generally not supplied or acquired on a separate basis, economic substitutability and competitiveness are to be determined by reference to, and occur between, the retail bundles of services which are supplied and acquired, which include retail fixed line rental services. Bundles of services which include mobile telephony services

⁹⁰ See 2006 Final Decision.

but not fixed line rental services, can also be economically substitutable for and competitive with bundles of services which include fixed line rental services.

The view that the LCS and WLR are supplied in a broader market encompassing all fixed voice services is supported by the analysis conducted in the Paterson Report, which concludes that there is evidence that a “cluster market” exists for retail fixed voice services.⁹¹ A cluster market is defined by the Commission as a market “comprising a bundle of related products, where the costs of unbundling mean that suppliers of the component products are unable to defeat a SSNIP by a hypothetical monopolist supplying the whole bundle of products.”⁹²

The Paterson Report sets out several attributes of the retail fixed voice services market that are consistent with the existence of a cluster market. These include:⁹³

- the available evidence on actual customer purchasing patterns suggests that almost all customers purchasing local telephony services from Telstra’s competitors are also purchasing national long distance services. It has been estimated that around [c-i-c] per cent of resale basic access lines are bundled with local call services and other fixed voice call services, and in respect of the retail market as a whole, [c-i-c] per cent of basic access lines are bundled with local calls and other fixed voice services;
- there are commercial grounds for concluding a broad market that includes all fixed voice services as Telstra and all of its closest competitors sell and market the full range of fixed voice services. For instance, Optus, Primus and AAPT all include local, national and international calls and fixed to mobile calls as part of their standard residential package. Further, the objective of carriage service providers appears to be to market and sell as many retail voice services to customers as possible, as opposed to marketing and selling particular voice services only; and
- bundling of fixed voice services also makes sense from the supply side, as the investments made in the retailing functions of a particular subset of retail fixed voice services (eg customer support, billing, marketing etc) can also be applied to other subsets of retail fixed voice services.

Furthermore, Dr Paterson suggests a number of unbundling costs, including the inconvenience of receiving multiple bills from splitting voice services between multiple

⁹¹ Paterson Report, pp. 13-14.

⁹² ACCC Merger Guidelines, June 1999, para 5.60.

⁹³ Paterson Report, pp. 13-15.

suppliers and as well as loss of economies of scope in relation to billing, customer acquisition and retention costs.⁹⁴

While Dr Paterson does not consider broadband services as part of the cluster market for retail fixed voice services, he notes that there are good reasons for including broadband services in the same retail market as fixed voice services on the grounds of supply side substitution and commercial reality.⁹⁵

Indeed, the Commission has itself acknowledged that:

“We have seen a shift from standard voice over telephone to an emphasis on broadband and all that flows from it, including internet, internet protocol television (IPTV), streaming of audio visual content and voice over internet protocol (VoIP).”⁹⁶

Functional market

Telstra agrees with the view expressed by the Commission in its 2006 Draft Decision that, in the case of LCS, there are no overwhelming efficiencies from vertical integration, thus indicating that there are various wholesale functional markets and substitutes as well as various retail functional markets that should be considered as part of the relevant market.

Temporal market

In the 2006 Draft Decision, the Commission expressed the view that the appropriate time for consideration of substitution possibilities is 2 years from 1 July 2006. Nevertheless, in the 2006 Final Decision, the Commission decided to re-declare the LCS for a period of 3 years from 1 July 2006, on the basis that (at page 9):

“a significant level of the uncertainty around network and service alternatives [to Telstra’s wholesale local services] is likely to have been resolved after two years”;

and

“a three year declaration period will mean that, at the commencement of the next review of these declarations, the currently uncertain state of competition and infrastructure deployment should be evident, and the ACCC will accordingly be better able to assess the appropriateness of continued declaration.”

Telstra agrees that it is relevant, when considering the appropriate duration of a declaration (or re-declaration) of a service to assess “the appropriate time for consideration of

⁹⁴ Paterson Report, p. 13.

⁹⁵ See Paterson Report, pp. 13-14.

⁹⁶ Ed Willett, Commissioner, speech “Understanding competition in the growth of Australian Broadband”, 21 November 2006.

substitution possibilities". However Telstra submits that this consideration of substitution possibilities must be undertaken on a forward looking basis, rather than focusing solely on the current extent of competition and infrastructure deployment at the time the decision to declare (or re-declare) the relevant service is made.

Telstra thus submits that the actual presence of sufficient alternative local access infrastructure or declared services, such as the ULLS, in particular geographic areas, whilst providing a sufficient basis for the granting of an exemption from the standard access obligations in respect of both the LCS and the WLR, is not a necessary precondition to the granting of such an exemption.

Telstra believes that a period of 3 years commencing 1 July 2006 represents a period over which the likely development of future competition and new infrastructure deployment can be usefully assessed for the purposes of the Exemption Applications.

Geographic market

As set out in the main body of this submission, the Commission has indicated a willingness in moving towards conducting marketing definition exercises at the local exchange level. This view is supported by Dr Paul Paterson in the Paterson Report and is adopted by Telstra in setting the scope of the Exemption Area.

Indeed, despite ultimately deciding that the declaration of the LCS should continue in all areas other than the five identified CBD areas, the Commission acknowledged in the 2006 Draft Decision that there is scope for "targeted withdrawals from regulation in sub-regions of the national market found to be effectively competitive outside the CBD areas".⁹⁷

Conclusions on market definition

While Part XIC does not require the relevant decision maker to take a definitive or determinative stance on market definition, Telstra's view on market definition and the appropriate scope of the Exemption Area is that:

- (a) an ESA based approach to market definition is appropriate for the purposes of the Exemption Applications; and
- (b) grouping together metropolitan, regional and rural areas as though they are homogeneous and failing to undertake a rigorous analysis of the level of competition in each distinct region or sub-region is likely to obscure and detract from the significant differences that exist between metropolitan areas and rural and regional areas.

⁹⁷ 2006 Draft Decision, p. 9.

