

**Remarks on CIE's response to JJ Pincus' comments on CIE's  
hedonic regressions**

**Second Report of JJ Pincus**

15 June 2017

Prepared on behalf of Telstra Corporation Limited for the Australian Competition  
and Consumer Commission's inquiry in relation to domestic mobile roaming

## 1 Executive Summary

*The CIE has undertaken a statistical analysis to compare Telstra's prices with the average prices of other mobile network operators. VHA has sought to rely on the CIE's report to claim that Telstra is earning a 'monopoly rent'. For the reasons given in this report, the CIE's report does not support this assertion.*

- 1.1 Tellingly, the CIE nowhere indicate what public policy implications, if any, can properly be drawn from their estimates.
- 1.2 Helpfully, however, the CIE explain what their hedonic regressions don't do:
  - (a) They do not show that Telstra has market power; and
  - (b) They do not explain the causes of what they call the 'price premium'.
- 1.3 Consequently, the CIE cannot claim that it has identified a 'price premium' that is caused by lack of competition and, to that extent, would have had policy significance.
- 1.4 VHA's own submission states that the 'price premium' estimated by the CIE includes 'legitimate competitive premium' and is not pure 'monopoly rent'.
- 1.5 On the basis of the CIE's regressions, it is entirely possible that one hundred per cent of Telstra's 'price premium', as estimated by the CIE, is due to Telstra's 'legitimate competitive premium', and that none is due to Telstra's alleged 'monopoly coverage'.
- 1.6 The clear implication is that the CIE estimates are useless for public policy purposes for which VHA puts them forward.
- 1.7 A copy of my instructions from Gilbert + Tobin on behalf of Telstra Corporation Limited are set out at Annexure A.

## 2 What the CIE estimated

- 2.1 Three matters seem indisputable:
  - (a) That the CIE stated that it was comparing Telstra's prices with the prices of the same services from the non-Telstra providers.
  - (b) That the CIE stated that the price premium was caused by a number of factors, including differences in coverage and quality of services.
  - (c) However, in its statistical analysis, the CIE did not include variables capturing coverage of services, and did not include any service quality variables that related to all or to a number of a provider's telecommunications plans.
- 2.2 The CIE say that theirs are estimates of a 'price premium', which phrase the CIE insists means just what the CIE choose it to mean—neither more nor less:

'The price premium was specifically defined as the difference between Telstra and a weighted average of other providers' (p. 5). But what matters is what their 'price premium' means, economically.

- 2.3 Simplifying, the estimates come from the regression of plan-specific prices against a set of plan-specific characteristics, and a dummy variable for the provider. The underlying assumption is that consumers value each characteristic according to the quantity of the characteristic, and not according to who is the provider. Thus, the regressions enable the CIE to estimate the portion of the provider's price that is unexplained by the plans' characteristics: the coefficient of the dummy variable is what the CIE calls the 'price premium'. The Telstra 'premium' is then compared with the weighted average premiums of the non-Telstra providers, and the excess is called "Telstra's price premium".
- 2.4 However, the CIE statistical technique did not account for service coverage and service quality, two factors that the CIE itself clearly stated affect the prices that Telstra can charge in the market (that is, while expecting roughly to maintain its market share). Thus, the CIE technique did not tease out what part of Telstra's prices was unexplained by what VHA calls Telstra's 'legitimate competitive premium'.
- 2.5 What the CIE did is somewhat like comparing the prices of Qantas' domestic flights, with the market-share-weighted average of the prices of Virgin, Jetstar and Tiger, with hedonic regressions adjusting the prices for differences in a set of flight characteristics such as city pairs, day and time of flight, type of airplane, baggage allowance and in-flight catering and entertainment and so on; and then calling the result 'the Qantas price premium', and attributing it to weak competitive pressures on Qantas, due to historical factors, whilst ignoring the possibility that the greater frequency of Qantas flights, and a consistently higher level of service on those flights, were regarded by many customers as superior to those of Jetstar and Tiger and worth paying a higher price for, all other things equal.

### **3 The CIE estimates have no policy relevance**

- 3.1 Far from being contested, my central claim seems to have been indirectly endorsed by the CIE: namely, that the CIE estimates are not fit for the purpose of public policy making.
- 3.2 In response to my report, the CIE state that 'a price premium is not sufficient evidence of market power' (p. 6). This important assertion seems to undermine completely any claims that the CIE's estimates of Telstra's 'price premium' have public policy relevance.
- 3.3 What remains entirely unclear and has not been addressed by the CIE is on what empirical basis, if any, they can claim that 'The premium for Telstra reflects ... limited competition', given that they have not tested for the presence or impact of market power. This statement is, in my view, a mere assertion, wholly unsupported by the CIE's analysis, and should be treated as such by the ACCC.

- 3.4 Moreover, their estimates cannot be taken as evidence that any policy-relevant Telstra ‘price premium’ exists, because they omitted to take account of coverage and quality of mobile and fixed line services. This omission was not because they believe them irrelevant; on the contrary, the CIE recognize their potential significance in explaining the pattern of prices across the various providers (as does VHA).

#### 4 VHA’s use of the CIE report

- 4.1 VHA correctly assert that the CIE had been asked to quantify the level of Telstra’s ‘price premium’ relative to the prices of Telstra’s competitors, and not to quantify market power (Supplementary Submission, Part A: 17).
- 4.2 Nonetheless, VHA interpreted the Telstra ‘price premium’ as a measure of Telstra’s ‘monopoly rent’ in the mobile market (see the VHA supplementary submission at pages 3, 11, 16, 86 and 87). In other words, VHA, in its submissions to the ACCC, represented the CIE’s results as an estimate of the quantum of monopoly rents and—until my report was lodged—the CIE in no way demurred from that misrepresentation.
- 4.3 However, although claiming the whole \$1.4bn as monopoly rent, VHA inconsistently admitted that at least some was not monopoly rent:

Some of that \$1.4 billion will constitute *legitimate price differentiation* by Telstra by means other than leveraging of its monopoly coverage. The challenge is therefore to un-entangle the monopoly rent component from Telstra’s *legitimate competitive premium*. (VHA Submission Part B, 5 Dec. 2016: 60, emphases added; see also a similar statement in its main submission, Part A: 130).

The CIE made no attempt to disentangle these elements.

- 4.4 This concession by VHA, although undoubtedly justified, did not go far enough: there is nothing in the CIE submission that disproves that *all of the estimated Telstra ‘price premium’ is a ‘legitimate competitive premium’*. In my opinion, the inescapable conclusion is that the CIE estimates of Telstra’s ‘price premium’ are worthless for public policy purposes.
- 4.5 The table below provides more detail of my claims and the CIE response, if any.

#### 5 Table: Pincus’ Claims and CIE responses

| <b><i>Pincus’ paragraph</i></b> | <b><i>Pincus’ Claim</i></b>  | <b><i>CIE’s response</i></b>  |
|---------------------------------|--|---|
| 1.2                             | There are no public policy implications from CIE estimates                   | Not contested; rather, price premium is ‘not sufficient evidence of market power’ |
| 1.3                             | CIE did not test for causes of ‘price premium’                               | Agreed  |
| 1.5                             | ‘Premium’ is due at least in part to quality differences, but not tested for | Agreed  |

|     |   |  |
|-----|---|--|
| 1.6 | Without an explanation of the differences in 'price premium' across providers, the CIE estimates are useless for policy purposes    | CIE was not asked to explain differences in premium across providers, and did not attempt to do so                             |
| 4.3 | CIE structural explanation must apply to the 'price premium' of non-Telstra providers   | 'The CIE report does not claim that its statistical analysis of the Australian price premium has identified structural issues' |
| 4.5 | CIE did not take account of fact that Telstra's fixed line prices are uniform across the country, but some other providers' are not | No comment   |
| 5.8 | Consumers are willing to pay more for what they believe is a superior service (not captured in the characteristics of the plan)     | No explicit comment, but agreement implied on pp. 2 – 3.   |
| 5.9 | By emphasizing comparisons of 'same' services, CIE has somewhat misrepresented hedonic regressions                                  | No comment   |
| 6.1 | Coverage affects willingness to pay, but is not included in the regressions   | Agreed   |
| 6.3 | CIE did not indicate how it compared prices in areas where Telstra was only provider (infinite non-Telstra prices?)                 | No comment   |
| 7.3 | How to explain Virgin's higher coefficient for data allowance?  | CIE did not attempt to explain what caused their results   |
| 8.1 | Providers target different market segments and price discriminate   | No comment   |
| 9.2 | Wrong methodology to force a unit coefficient on 'included content'   | Disagreed: not been shown that it would make a difference  |

## ANNEXURE A

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**15 June 2017**

**By email**

Professor Jonathan Pincus

Email: [jjpincus@gmail.com](mailto:jjpincus@gmail.com)

Dear Professor Pincus

### **Response to the Australian Competition and Consumer Commission regarding potential declaration of a wholesale domestic roaming service on behalf of Telstra Corporation Limited**

#### **1 Background**

- 1.1 We refer to our letter to you dated 23 January 2017, engaging you on behalf of Telstra Corporation Limited (**Telstra**) to provide a report in relation to an inquiry commenced by the Australian Competition and Consumer Commission (**ACCC**) into whether to declare a wholesale domestic mobile roaming service (**ACCC Inquiry**).
- 1.2 The ACCC invited submissions to the Discussion Paper from mobile network operators. Submissions were provided by a number of operators, including Telstra and Vodafone Hutchison Australia Pty Ltd (**VHA**). VHA provided a supplementary submission and supporting documents in March 2017 (**VHA's Supplementary Submission**). As part of that material, VHA provided a second report from the Centre for International Economics dated 23 February 2017 (**Second CIE Report**).
- 1.3 We have been instructed to engage you, on behalf of Telstra, to prepare a report based on your expert opinion, for use by Telstra in relation to the ACCC Inquiry. Telstra may seek to rely upon your report in any subsequent review of the ACCC's final decision. If that occurs, we will contact you.
- 1.4 By this letter, we set out our written instructions to you.

#### **2 Scope of work**

- 2.1 You are retained to provide an expert report which comments on:
  - (a) the Second CIE Report; and
  - (b) the use of the Second CIE Report in VHA's Supplementary Submission.

### 3 Guidelines for preparing your report

- 3.1 While you have not been engaged in respect of any legal proceedings, Telstra is seeking a robust and rigorous independent expert report. We request that you prepare your report in accordance with Federal Court of Australia *Harmonised Expert Witness Code of Conduct*. A copy of the Code of Conduct is enclosed at **Attachment A**.
- 3.2 In particular, in preparing your report, we ask that you please:
- (a) identify your relevant area of expertise and provide a curriculum vitae setting out the details of that expertise;
  - (b) only address matters that are within your expertise;
  - (c) where you have used factual or data inputs please identify those inputs and the sources;
  - (d) if you make assumptions, please identify them as such and confirm that they are in your opinion reasonable assumptions to make;
  - (e) if you undertake empirical work, please identify and explain the methods used by you in a manner that is accessible to a person not expert in your field;
  - (f) confirm that you have made all the inquiries that you believe are desirable and appropriate and that no matters of significance that you regard as relevant have, to your knowledge, been withheld from your report; and
  - (g) do not provide legal advocacy or argument and please do not use an argumentative tone.

### 4 Confidentiality and legal professional privilege

- 4.1 Presently, your report and all correspondence between us (excluding this letter) is subject to legal professional privilege. In addition, the information we have provided to you is commercially sensitive and confidential. For these reasons, we request you do not disclose or discuss your report, our correspondence or any information we provide to you with any third parties.

Yours faithfully  
**Gilbert + Tobin**

A handwritten signature in black ink, appearing to read 'Peter Waters'.

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## Attachment A

### ***Harmonised Expert Witness Code of Conduct*** **(Annexure A to Federal Court of Australia Practice Note GPN-EXPT)**

#### APPLICATION OF CODE

1. This Code of Conduct applies to any expert witness engaged or appointed:
  - (a) to provide an expert's report for use as evidence in proceedings or proposed proceedings; or
  - (b) to give opinion evidence in proceedings or proposed proceedings.

#### GENERAL DUTIES TO THE COURT

2. An expert witness is not an advocate for a party and has a paramount duty, overriding any duty to the party to the proceedings or other person retaining the expert witness, to assist the Court impartially on matters relevant to the area of expertise of the witness.

#### CONTENT OF REPORT

3. Every report prepared by an expert witness for use in Court shall clearly state the opinion or opinions of the expert and shall state, specify or provide:
  - (a) the name and address of the expert;
  - (b) an acknowledgment that the expert has read this code and agrees to be bound by it;
  - (c) the qualifications of the expert to prepare the report;
  - (d) the assumptions and material facts on which each opinion expressed in the report is based [a letter of instructions may be annexed];
  - (e) the reasons for and any literature or other materials utilised in support of such opinion;
  - (f) (if applicable) that a particular question, issue or matter falls outside the expert's field of expertise;
  - (g) any examinations, tests or other investigations on which the expert has relied, identifying the person who carried them out and that person's qualifications;
  - (h) the extent to which any opinion which the expert has expressed involves the acceptance of another person's opinion, the identification of that other person and the opinion expressed by that other person;
  - (i) a declaration that the expert has made all the inquiries which the expert believes are desirable and appropriate (save for any matters identified explicitly in the report), and that no matters of significance which the expert regards as relevant have, to the knowledge of the expert, been withheld from the Court;
  - (j) any qualifications on an opinion expressed in the report without which the report is or may be incomplete or inaccurate;
  - (k) whether any opinion expressed in the report is not a concluded opinion because of



insufficient research or insufficient data or for any other reason; and

- (l) where the report is lengthy or complex, a brief summary of the report at the beginning of the report.

#### SUPPLEMENTARY REPORT FOLLOWING CHANGE OF OPINION

- 4. Where an expert witness has provided to a party (or that party's legal representative) a report for use in Court, and the expert thereafter changes his or her opinion on a material matter, the expert shall forthwith provide to the party (or that party's legal representative) a supplementary report which shall state, specify or provide the information referred to in paragraphs (a), (d), (e), (g), (h), (i), (j), (k) and (l) of clause 3 of this code and, if applicable, paragraph (f) of that clause.
- 5. In any subsequent report (whether prepared in accordance with clause 4 or not) the expert may refer to material contained in the earlier report without repeating it.

#### DUTY TO COMPLY WITH THE COURT'S DIRECTIONS

- 6. If directed to do so by the Court, an expert witness shall:
  - (a) confer with any other expert witness;
  - (b) provide the Court with a joint-report specifying (as the case requires) matters agreed and matters not agreed and the reasons for the experts not agreeing; and
  - (c) abide in a timely way by any direction of the Court.

#### CONFERENCE OF EXPERTS

- 7. Each expert witness shall:
  - (a) exercise his or her independent judgment in relation to every conference in which the expert participates pursuant to a direction of the Court and in relation to each report thereafter provided, and shall not act on any instruction or request to withhold or avoid agreement; and
  - (b) endeavour to reach agreement with the other expert witness (or witnesses) on any issue in dispute between them, or failing agreement, endeavour to identify and clarify the basis of disagreement on the issues which are in dispute.