



## **Submission to SAU Discussion Paper January 2013**

### **Background and context**

The CCC believes that the NBN changes the character of communications markets at a fundamental level. The separation of the underlying network from retail markets, and the prescription on NBN Co to operate as a wholesale-only business, removes what has been the single greatest barrier to the development of sustainable competition since the Federal Government opened the market to competitive entry in 1997.

NBN Co will, at the highest level, have incentives to maximise the use of its network and encourage retailers to migrate to it as quickly as possible.

It is crucial, however, to retain sight of the fact that NBN Co in most locations will, and is intended to be, a monopoly provider of customer access services. The CCC accepts that the greatest national welfare gains are likely to be achieved by accepting that some elements of the communications network are natural monopolies and treating them as such. The duplication of the HFC networks in some parts of Australian cities illustrates the folly of investing in duplicate infrastructure that cannot be supported by retail demand.

The corollary of allowing one business to operate as a monopoly is that appropriate regulatory arrangements must be put in place to ensure that this market power is not exercised to the ultimate detriment of consumers. The experience in the energy sector, which has been structurally separated and has seen the introduction of competition over the past 20 years provides important lessons in this regard, in particular in relation to investment behaviour and the impact on consumer prices.

However, there are important differences in the nature of communications markets that must also be considered in finalising the forward-looking regulatory environment that will apply to NBN Co under an SAU. The most obvious is that the retail services and consumer prices have proven to be subject to dramatic and unpredictable changes. Often, these changes have been pioneered by new entrants.

Members of the CCC, for example, were the first in Australia to introduce 3G mobile services, consumer Internet access, unshaped broadband, ADSL2+, Naked DSL, and “bucket plan” pricing.

This past experience is important because it illustrates the potential for the incentives driving NBN Co to not always align with the best outcome for competition in the longer term in all cases.

The CCC notes that NBN Co does not explicitly state as one of its objectives the promotion of competition. Rather, it has said that this is implicit because it is structurally separated from any retail activity and is motivated to maximise downstream activity. Further, NBN Co has said that it is subject to non-discrimination obligations and to the direction of its shareholder, the Federal Government, and that this provides a further important constraint on its conduct.

While this is true, the CCC submits that the incentives and market dynamics are more complicated than NBN Co's thinking allows. Most importantly, the market position and interests of access seekers will in some cases differ in ways that do not occur in energy markets.

Not only will the interests of access seekers differ, but NBN Co is likely, over time, to find that it has incentives to be more responsive to some access seekers than others, particularly those that have greater scale or incumbency.

The CCC notes that it is not our view that the non-discrimination principles are intended to deal or capable of dealing with these circumstances.

This dynamic has already been illustrated twice in the short history of NBN Co's engagement with access seekers. At the ACCC's forum into the SAU in December, NBN Co clarified remarks it had made in a letter declaring it had achieved consensus in its discussions about the terms of its latest access agreement, saying it had in fact reached a conclusion. It had found that consensus was impossible to achieve and so had concluded discussions, and determined itself what were the most appropriate terms.

Secondly, let us consider the approach NBN Co has taken to the negotiation to migrate traffic away from existing HFC networks to its own network. NBN Co first concluded an agreement with Telstra as a part of its Definitive Agreement, closely followed by reaching agreement with Optus. Negotiations with iiNet/TransACT in relation to the HFC networks operated by the iiNet group of companies have been given a low priority, to the frustration of iiNet/TransACT.

Another issue that has yet to be fully explained is the way in which NBN Co determined the relative prices of its CVC and multicast services. These prices have important implications for the business cases of retailers, with the interests of horizontally integrated providers, pure broadband/voice providers and OTT content providers being potentially different.

In all of these cases, the ultimate arbiter of whose interests were favoured was NBN Co, against priorities that were internal to itself.

In addition to these complications pertaining to the nature of retail markets, NBN Co will operate in wholesale markets where it is likely to be offering services in competition with private providers. In some situations, it is likely to be competing with companies that also have access networks in CBD locations. This has the potential to create incentives for NBN Co to leverage its monopoly access power to advantage in competitive areas and in so doing, discourage competition in wholesale markets.

Additionally, the Government has stated that it intends to eventually privatise NBN Co. This is likely to be at least considered, if not concluded, during the 30 year term that the SAU is intended to cover. That is, the elements of the SAU and the conditions it establishes for the operation of the NBN need to be able to endure privatisation, which would result in NBN Co being subject to directions and motivations from its new owners, which are different to those of the Government.

The CCC believes that in conditions where NBN Co benefits clearly from unequal bargaining power, and where those relying on it for access to consumers have no alternative source of supply, the ability to seek regulatory recourse in the case of disputes is unquestionably necessary.

NBN Co has repeatedly objected to arrangements that provided for a broader regulatory recourse mechanism on the basis of a perceived risk that downstream access seekers would litigate all commercial matters if such an opportunity was available. The CCC rejects this completely as a misrepresentation of the past conduct of access seekers, and a failure to understand the incentives faced by downstream operators in competitive markets. Historically, regulatory processes have been slow, uncertain and expensive and as such, the resolution of access arrangements through these avenues has advantaged vertically integrated incumbents. This has meant that there was no incentive for monopoly access providers to avoid regulatory arbitration processes, and therefore little cause for access seekers to resolve disputes through commercial means. In addition, the previous part XIC regime required the ACCC to arbitrate a dispute on a bilateral basis, once it had been lodged.<sup>i</sup>

The CCC accepts that NBN Co does not have the same incentives as vertically integrated access providers, but it, too, should understand that there are powerful incentives for access seekers to reach satisfactory commercial negotiations without regulatory intervention. In fact, the absence of credible regulatory oversight mechanisms acts as a disincentive to downstream access seekers reaching commercial agreement with a monopoly supplier, because access seekers will always be concerned at the risk associated with concluding a deal that locks out future independent recourse to, or oversight by, the independent regulator.

### **Proposed amendments to the SAU**

It is against this background that the CCC proposes some elements of the NBN Co SAU that require reconsideration before they can be considered reasonable.

The 30 year term of the SAU is unprecedented and - notwithstanding the modular structure - on its face must present very real risks of effectively locking in a set of arrangements that cannot be expected to endure, given the pace of change in not only the communications sector but also the digital economy.

The modular structure of the SAU is an innovative approach that lends itself to allowing certain matters to be quarantined and locked in under an acceptable long-term structure, and other matters to evolve and be subject to review and oversight in order to ensure they remain reasonable over this period. The inclusion of high level commitments to the pricing principles should provide the certainty NBN Co requires to secure financial market support for its capital requirements.

The CCC submits that this modular structure should be used so the SAU can strike the appropriate balance between the need to provide NBN Co with the certainty that it needs to support its investment, capital and long-term cost recovery requirements, against the risk of inadvertently creating circumstances that constrain the evolution of dynamic communications markets over time.

To achieve this, the CCC submits that given the 30 year term the SAU should seek to establish lock-in of only those matters that can be justified as being necessary to establish a long term framework under which NBN Co is able to meet its objectives, including the ability to recover its costs. In practical terms this is likely to include matters which the NBN Co SAU seeks to address with Long-Term Revenue Constraint, the Initial Cost Recovery Account, methodology for calculation of the RAB and certain other rules for the replacement module phase. For clarity, the CCC is not submitting that

these schedules as they are presently drafted are reasonable and should be accepted without further specific examination, and notes comments from other stakeholders pointing to how these mechanisms might need refinement.

Other matters, including some currently incorporated as fixed principles in Module 0 or 2, are more appropriately subject to more frequent and independent review and recourse, to ensure that the detailed terms in the SAU continue to promote the relevant matters in Part XIC, including the LTIE, over the 30-year term. For example, this includes prescriptive detail around the updating of reference offers which may constrain the future ACCC oversight of these matters (Schedule 2B); certain pricing commitments (such as the CPI-1.5% price cap level and arrangement for the setting of new prices) which are appropriate for review by the ACCC given the 30 year time period; and, certain matters incorporated into Schedule 2F around the future evolution of service levels. The CPI -1.5% price path should be subject to review to consider if it remains adequate to reflect market expectations, but there must also be scope to consider in the future the need to rebalance pricing of different components.

The modular structure of the SAU should allow for the pricing structures of NBN Co's wholesale services to be flexible enough to respond to changes in the market over time. Communications markets continue to be very rapidly evolving, as evidenced by the way demand for the highest available bandwidths via NBN Co has outstripped its own expectations for take up.

For this reason, the CCC submits that there must be the ability for pricing structures, individual prices and price caps and relevant non-price terms to be reviewed by the ACCC at regular intervals. Any proposed adjustments or substitute terms that adjustments/reviews would be subject to those matters locked in for the 30 year term.

The CCC submits that it is appropriate that during the early period of the SAU, NBN Co is given some certainty and flexibility. This is because NBN Co is in effect a start-up at this point and will be experiencing very large capital expenditure and low revenue at the same time as it is likely to be experiencing a very steep learning curve in its internal operations and commercial relationships.

It is not, however, clear that the distinction between the construction and post construction phases is entirely valid for the purposes of designing the regulatory regime that will govern NBN Co's pricing activities, including the term of each module and location of review points. Given the progressive nature of the rollout and the migration deals already completed, in the latter part of the rollout period NBN Co should be operating on a more stable basis and earning more predictable and consistent revenues.

The regulated review periods, therefore, do not need to be designed solely to align with NBN Co's rollout timetable, but should reflect generally the timeframe on which it will achieve scale and balance this against review periods that reflect the regulatory risk presented by changing circumstances and market and consumer needs.

It is important that there is at least one mid-construction term review within this period, four years from the commencement of an accepted SAU, but probably more appropriately after four years. The CCC believes there should be reviews every four years from that point, which would mean the

second review period would align with the back-end of the construction phase of the NBN rollout and with network coverage having achieved near universal scale.

The mid-term review could be more confined in scope than subsequent reviews, acknowledging that NBN Co will still be in a relatively early stage of its development and reflecting the depth of the ACCC's consultation to date and the likelihood that some of the pricing structures presently proposed will still be reflective of retail market needs in 2016. Proposed AVC pricing and price cap models, for example, could be excluded from this review.

Building on the mid-point review proposed by NBN Co some further limited matters should be incorporated into a mid-term review of the SAU after the first 4-5 years. For example, CVC prices and multicast prices versus unicast prices should be reassessed with a view to the development of downstream markets and competitive business models emerging in Australia and overseas to determine if they remain reasonable and consistent with the LTIE.

Another area where the CCC submits that the SAU is deficient relates to the prices, terms and conditions for new products. As discussed above, the interests of downstream access seekers can differ and NBN Co's incentives to be responsive to them can also vary. While the locked-in prices for already available services provides some context and may create some anchor constraint on prices, in some cases this may be a weak constraint.

By definition, it is difficult to envisage what new products might become available or what products access seekers might seek. However, it is likely, and entirely understandable that in some cases NBN Co would be more responsive to requests for new products from existing, large customers than it would be to new entrants. This is consistent with NBN Co's often stated objective of maximising traffic on its network. However, as the experience of the past 15 years, which has seen CCC members pioneer new markets from very small initial customer bases, the disruptive products and prices in communications markets are likely to come from entrants, niche participants and/or competitors without market power.

Further, the CCC submits that the question of how existing prices provide constraints on the level of prices for new services is more complex than simply a matter of whether existing prices create a "ceiling". Services can be priced too low, or the terms and conditions of access can be such that a particular service is offered in a manner that discriminates in favour of a particular access seeker or discriminates against others, whether by design or otherwise.

The relationship between the prices of multicast compared to unicast services could provide an example of exactly such a situation.

The CCC submits that these factors mean it is crucial that there is scope for independent review of new product price, terms and conditions by the ACCC to be available. However, the CCC does not propose that this should be a process of approval for all prices for new services. Rather, it is proposed that this be a "by exception" oversight power where the ACCC is of the view that there are grounds to believe that there is a potential competition, LTIE test, or reasonableness concern with a new price set by NBN Co. The ACCC should be empowered to address these concerns through its usual statutory processes and would be able to make access determinations (AD's) or binding rules

of conduct (BROC's) to remedy any problems it identifies. This could be achieved by ensuring that new prices are not ruled out from the regulatory recourse mechanism.

In a similar vein, the CCC submits that there should be greater independent oversight of future NBN Co increases to \$0 priced non-reference 'other charges'. As understood, NBN Co currently proposes to treat these in a similar fashion to the introduction of a price for a new product, where it would set the new price having regard to the Initial Pricing Principles. Given that these services are likely to be essential inputs for delivering services on the NBN (e.g. installation, modification and on-site maintenance call outs) without market alternatives or an anchoring effect from existing price points, there should be a greater degree of independent scrutiny of changes to these price points.

Another area related to prices that the CCC submits needs reconsideration relates to prudence of investment and the extent to which NBN Co investment is deemed to be efficient. Again, the CCC accepts that there is a good argument in the early rollout years for NBN Co to be afforded flexibility with regard to prudence issues. However, the CCC is concerned that there are extremely large areas of expenditure, including expenditure to large downstream retailers Telstra and Optus, which are deemed efficient. These expenditures clearly have the potential for having impacts on competitive conduct. If they are not efficient, competitors suffer a double blow – their retail competitors gain windfall benefits and they themselves pay inflated prices over time to allow NBN Co to recover these costs.

The CCC is also concerned at the service description used in the SAU and the potential regulatory reach implications of it. In Attachment A to Module 0 of the SAU, NBN Co defines the NBN Access Service in extremely broad terms so that it effectively covers any layer 2 service that is, or might be, provided over the NBN. This very broad definitional approach contrasts with the more narrowly defined service descriptions that have traditionally been used by the ACCC in relation to declared services. The impact of this approach is to greatly limit the ability of the ACCC to exercise its powers to determine the services that NBN Co is required to provide. Pursuant to s.152AL(8F), the ACCC retains the power to declare new services, even where such services are covered to some extent by a special access undertaking. However, if a new service declared by the ACCC falls within the bounds of the broadly defined NBN Access Service, in accordance with s.152AY(b)(ii), NBN Co's standard access obligations in relation to any such service will be as set out in the SAU. In addition, the SAU provides that the variation of existing services and the creation of new services is ultimately within the sole discretion of NBN Co (see for example 2E.4.3). As set out in s.152CBIA, to the extent that any access determination is inconsistent with this approach, and sought to overrule NBN Co's discretion in relation to defining products or product features, such an access determination would be of no effect.

Accordingly, it can be seen that the SAU has the effect of drastically curtailing, or possibly totally excluding the power of the ACCC to intervene in the process for varying existing products or creating new products for the entire duration of the SAU. Experience has shown that market requirements for telecommunications products shift rapidly. It has consistently been the case over recent decades that products move from being mainstream staple products to being totally superseded within a timeframe of 5 years or less. Changes in service requirements have been a consistent source of dispute between suppliers and acquirers under the existing telecommunications regime. In this environment it is not appropriate to allow NBN Co, a monopoly provider facing no competitive

tension, to have sole discretion to determine the specifications of the services to supplied to wholesale customers. It is not realistic to assume that such an approach will produce the most efficient outcomes and be in the long term interests of end users. It is virtually inevitable that tensions and disputes will arise between the interests of NBN Co and access seekers in relation to the specifications of the services supplied over the NBN, and it is appropriate that the ACCC has the ability to intervene to resolve such disputes when required.

NBN Co's letter to Optus of 14 January 2013 also suggests that the long term revenue constraint should be disregarded as being effective in acting as a constraint on NBN Co. The letter makes clear that NBN Co's own projections show that the Long Term Revenue Constraint will not come into effect during the term of the SAU. NBN Co asserts that this should provide comfort to access seekers as it implies that access seekers have been able to purchase NBN Co's services at prices that have not yet enabled NBN Co to recover its prudently incurred costs of supply (inclusive of an appropriate return on capital). However, this also makes clear that the LTRC will in fact impose no realistic constraint or limitation on NBN Co's pricing of services during the term of the SAU or at least for many years. In addition, it provides absolutely no assurance that the price of individual services offered by NBN Co are efficient, appropriate or in the LTIE. It would be perfectly possible for NBN Co to be within the LTRC, and yet for individual services or service components to be priced at uneconomic levels.

### **Summary of recommendations**

In Summary, the CCC proposes:

- The modular structure and the overall 30 year SAU term be accepted but with some modifications.
- Those terms and conditions locked in as 'fixed principles' for the full 30 year term (referred to as Modules 0 and 2 in the current version of the SAU) should seek to establish lock-in of the minimum number of matters that are justified in order to provide NBN Co with a sufficient level of long term certainty required for it to be able to achieve its objectives, including the recovery of its efficiently incurred costs.
- Building on the proposed mid-point review, limited products should be subject to price review in the mid-term review after four or five years. These would include CVC and multicast prices.
- The CCC submits that it is reasonable for the three initial reference AVC offers to be exempt for regulatory oversight – including from the first review – for the first eight years of the undertaking. This reflects the fact that these are intended to be the services that facilitate the smooth transition from the copper-based access network to the NBN Co.
- Other prices, including new products and non-reference offers, should be subject to oversight, subject to the requirement to be consistent with Module 0 and 2. The uncertainty about how the market will develop means that it is necessary to allow for the Commission to be asked to examine whether conduct and commercial arrangements met the LTIE. For example, the unanticipated high demand for 100mbps services among early adopters demonstrates the

degree of uncertainty about the pace of change on retail markets. As the market moves to high bandwidth products, there is the potential for different retailers to have different interests in relation to pricing relativities, and NBN Co cannot be expected to adjudicate between these interests and take account of the LTIE, as discussed above. Therefore, it is not reasonable to quarantine NBN Co prices from ACCC oversight as the present SAU proposes.

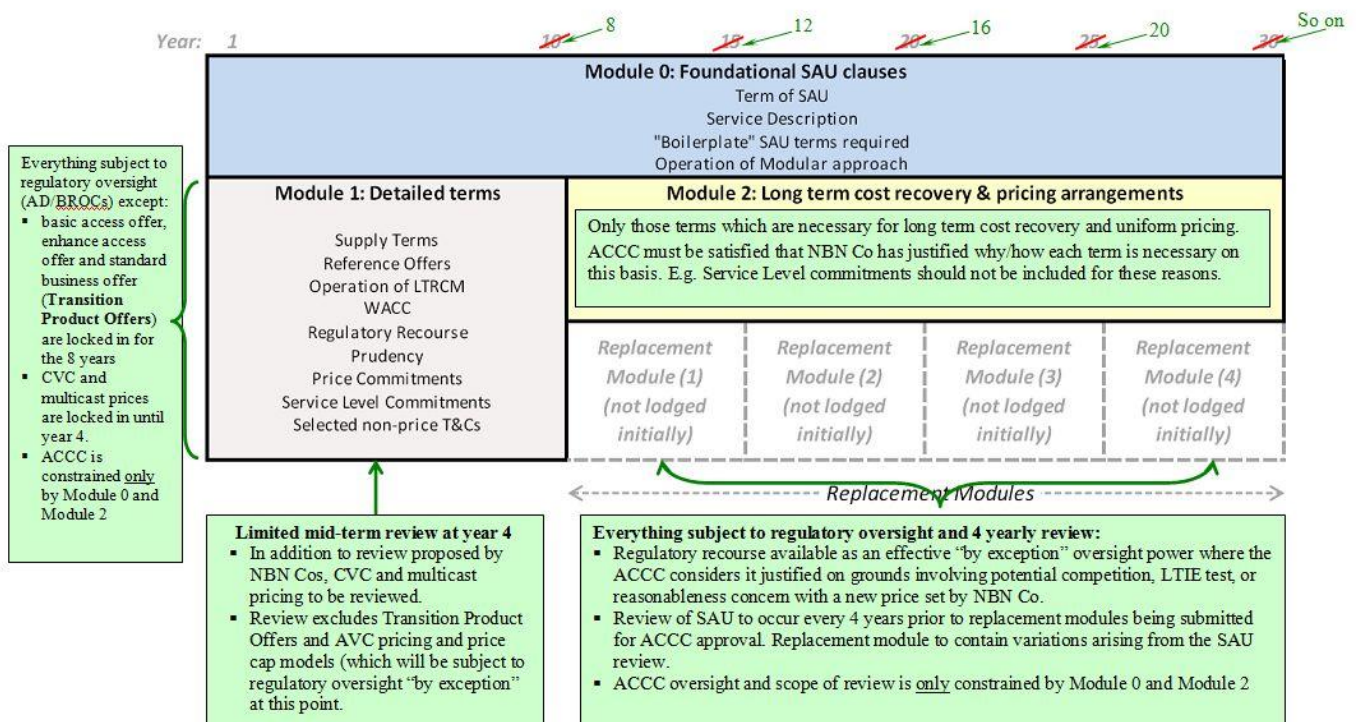
- Replacement modules introduced after the expiry of the eight year term of module 1 should be presented and assessed by the Commission based on its accepted SAU processes. These replacement modules would be subject to the matters accepted by the Commission in Module 0.
- NBN Co must make more specific commitments in relation to CVC price reductions. This should take the form of a commitment to a minimum reduction pathway if certain demand and usage forecasts are met. NBN Co has indicated that it intends to reduce CVC prices but this commitment must be much more specific if an environment supportive of investment by other businesses is to be created. Other participants in communications markets are and will increasingly be making complementary investment decisions based on the market conditions that are created by NBN Co's pricing regime for access to its monopoly infrastructure. In seemingly affording itself flexibility to make decisions about CVCs pricing in the future, NBN Co assigns risk and uncertainty to investors in competitive markets served by NBN Co.
- In circumstances where access seekers have not reached a satisfactory conclusion in their negotiations with NBN Co at the expiry of their access agreement and are seeking regulatory redress such as through an access determination, the agreement must allow for any regulated terms to be immediately incorporated. That is, in circumstances where access seekers have sought regulatory intervention, they should under no circumstances be forced to sign agreements that deny them access to the outcome of regulatory enquiries until the end of a new two year co-terminus period.
- The SAU should make clear that the ACCC is able to direct that, where it regards it as appropriate, it can make elements of a determination mandatory. That is, if the ACCC believes there are important competition elements or the non-discrimination obligations require it, NBN Co will be required to amend all access agreements to reflect a determination by the Commission, rather than giving access seekers the option to not have those determinations reflected in their subsequent access agreements.
- Subsequent reviews after the mid-term review, the first of which should occur as the construction period is nearing completion about eight years from the acceptance of the SAU, should be conducted on a four yearly cycle and should include a holistic review of pricing structures, price caps and individual prices and relevant non-price terms, subject to certain fixed principles and other matters which are locked in for the 30 year term. These reviews should provide an opportunity to determine if these matter continue to promote the relevant matters set out in Part XIC, including the LTIE.
- It is inappropriate for BROCs to be treated synonymously to AD's and implemented only on the expiration of existing agreements. Also, it is not acceptable that parties would be able to choose



not to incorporate conditions specified in BROCs, as NBN Co appears to intend through its proposed mechanism. It would be against the policy intention of this tool if the ACCC were to consider that certain market activities were sufficiently harmful to end users that they justified a BROC, only for the parties undertaking that conduct to choose not to give effect to that ACCC decision by choosing not to incorporate it into its agreement with NBN Co.

- The CCC submits that BROCs are intended to be a regulatory tool that enables the ACCC to act quickly and effectively in response to identifying conduct that it regards as anti-competitive or against the interests of consumers. BROCs are effective for periods of 12 months, further evidence that they are intended to be used as “first strike” tools in circumstances where the ACCC concludes immediate action is warranted. This risk arises because the SAU prevents the ACCC from taking action inconsistent with an accepted SAU.
- This flaw in the SAU as it is proposed should be corrected in two ways.
  - Firstly, in keeping with the CCC’s view that the 30 year lock in element of the SAU should not seek to cover matters other than those that are necessary, it is important that the ACCC makes a thorough review of the scope of the SAU to ensure it does not prevent the ACCC from exercising its regulatory functions unduly.
  - Secondly, BROCs should not be treated as synonymous with AD’s and incorporated into agreements through the same mechanisms. NBN Co should instead commit to immediately implementing any BROC into its access agreements on whatever terms the ACCC determines are necessary. This would be consistent with the intention for which BROCs were created.

The structure of the revised SAU can be illustrated as follows:



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<sup>i</sup> The very high number of access disputes in the past has often been raised as evidence of a culture that lent itself to disputation rather than commercial agreements between access providers and access seekers. NBN Co appears to regard this history as evidence that there is risk of access seekers behaving vexatiously if broader access to regulatory recourse is available under the new regime.

The CCC submits that this misrepresents the market dynamics in the past. Prevailing circumstances during that period where access to customers was controlled by a vertically integrated incumbent, and a regulatory regime based on the negotiate-arbitrate model assumed access provider conducted that was not aligned with its fundamental incentives.

The result was that access seekers routinely found that Telstra was an unwilling seller of access and was advantaged by delaying the resolution of access disputes. Telstra used the process as a deliberate tactic to avoid commercial negotiation and to delay the rollout of innovative services by its competitors. The “gaming” was actually driven by the access provider – not the access seekers. Access seekers were drawn into bilateral access arbitration processes to settle these disputes, but found that even when these were resolved for one access seeker, Telstra did not necessarily make available to all access seekers the prices, terms and conditions determined by the ACCC in bilateral disputes.

As a result, numerous access seekers were increasingly forced to initiate simultaneous access disputes in relation to the same services in order to ensure that they all gained the benefit of ACCC decisions. These actions were intended to more effectively and speedily resolve disputes, because it enabled the ACCC to consider multiple disputes in a single process.

The CCC submits that this history is evidence that access seekers respond to incentives to settle access arrangements as quickly and efficiently as possible, not that they are litigious and prone to seek regulatory “gaming” opportunities. In effect, the flaws in the previous regime and the realities of the conduct of a vertically integrated access provider created an environment to which they were forced to respond.

The CCC submits that the regulatory arrangements put in place to oversee NBN Co’s operations should reflect good regulatory design, and acknowledge the unequal bargaining power of a monopolist access provider and its downstream customers, without being distracted by the behaviour of market participants responding to the previous, flawed, market arrangements. The amendments to Part XIC create an opportunity to create an oversight and recourse mechanism that is more balanced and efficient than was previously the case.