Submission on the Draft Decision on Telstra WLR and LCS Exemption Applications

May 2008

Introduction

The CCC welcomes the opportunity to respond to the Commission's draft decision on the Telstra applications for exemption of the WLR and LCS services. The CCC represents leading competitors to Telstra in most communications markets in Australia, including residential and corporate broadband and voice. Its members have pioneered many of these markets since the 1990s, have been extensive users of wholesale voice services, have been leading and early investors in ULLS-based services and have invested in the order of $5 billion in total.

Summary

The CCC submits that the Commission's draft decision is poorly thought through and represents a willingness to take risks with the future of competition and consumer interests that ill-behoves an agency charged by the Government with defending those interests.

The draft decision represents a willingness on the part of the Commission to accept further concentration in an industry that is already suffering from a level of concentration unprecedented in the developed world. The CCC is concerned that this willingness to allow, and in this case encourage, greater concentration fits a pattern of decision-making that the Commission should have realized is doomed to fail consumers.

The CCC submits that the Commission has presided over market concentration in the grocery and petrol industries in recent years, and in both cases it is now obvious Australian consumers have been failed badly.

In the light of these lessons and the arguments below, many of which have been presented before and ignored or dismissed in the draft report, the CCC submits that the Commission's willingness to contemplate accepting Telstra's application for exemption from regulation represents a dangerously wrong-headed understanding of the interests the Commission should be defending and promoting.

The Commission should therefore reject Telstra's application for exemption on the primary ground that it is not reasonable when considered against the legislative criteria. Alternatively, if the Commission was minded to accept the potential for the exemption application to be reasonable, then it ought to adopt a minimum two year implementation horizon commencing 1 January 2009.

The Commission Should Look to LTIE and Not Be Seeking to Placate Telstra

The CCC submits that the Commission's draft decision reflects a regulatory adventurism of a type not seen before neither in Australia nor anywhere else in the world. The Commission appears to have become completely confused by the discourse it initiated in

2006 about the desirability of removing regulation in circumstances where regulation was demonstrably redundant.

The Commission, consistent with the broad industry view and the original intention of the Parliament, has in the past been understood by competitors to believe that regulation could be wound back in some markets when effective competition had been established. This was the proposition that the CCC understood to be the underpinning approach informing the Commission's strategic industry review discussion papers. The Commission should not feel obliged to do anything just because Telstra has responded to the initiation of a discussion about the circumstances under which the Commission will wind back regulation by making exemption applications.

The CCC repeats its fundamental response to the proposition that it would be pre-emptively removing regulation of wholesale services. In particular, if the Commission believes in the efficacy of the stepping stones approach, the appropriate time for the roll back of what are currently regulated services will be obvious. However, what is currently self-evident is that competitors have not yet moved to reliance on higher margin, infrastructure-based investments. When that time arrives, the proposed roll back will not be a contentious decision.

The Commission should be mindful that sufficiently strong incentives to encourage efficient migration to ULLS already exist, and these incentives have over the last four to five years driven service providers, led by CCC members, to make substantial investments in ULLS-based services. Some of the stronger incentives are the desire to reduce dependency on Telstra's infrastructure (thereby reducing the scope for anticompetitive interference) and the prospect of earning the necessary cash flows to further invest in, and market, retail services.

If competitors are already moving to deliver services based on deeper investment because it is in their own interests, and if the biggest barriers to the expansion of this investment continue to be factors beyond their control, the Commission should focus its attention on facilitating effective access. It should not remove regulated services. To do so has the effect of punishing competitors that are trying to migrate their business model toward infrastructure based offerings – an objective hitherto consistent with policy and regulatory settings. Not only is the Commission's Draft decision an "about face" on its recent investment signals, it is nearing scandalous that the Commission is attempting a backflip when uncertainty around infrastructure investment in the sector generally and copper based investments specifically, are at a high point.

Neither Telstra nor the ACCC has sufficiently demonstrated that removal of the declaration in the proposed ESA's would lead to a more efficient outcome. It is the CCC's contention that the likely outcome of the Draft decision being implemented is that wholesale and retail market share would again concentrate around Telstra and that operators would "stand aside" from investing until the full implications of both the decision and the FTTN debate are played out over the coming years.

It was predictable that Telstra would take discussion about future regulation as an opportunity to press the Commission to pre-emptively wind back regulation. It is surprising the Commission has taken the bait and proposed to remove regulation in circumstances where it has itself concluded that there is not effective competition. This is completely contrary to the philosophy underpinning the stepping stone approach that the Commission has promoted to access seekers in recent years. Further, it creates uncertainty and therefore disruption to competitors' business plans that, the CCC submits, is contrary to the long term interests of end users.

It beggars belief that the Commission can assert each of the following:

- "At the wholesale level, Telstra controls the infrastructure by which the overwhelming majority of voice services are provided and is the main supplier of LCS, WLR and ULLS to competitors."[1]
- "At a national level, Telstra retains the dominant supplier of retail fixed voice services."[2]
- "Similarly, the ACCC has limited evidence that the price and non-price retail outcomes in the Proposed Exemption Areas have been materially effected by the increased level of ULLS-based competition, to date."[3]

Yet the ACCC arrives at a draft position in relation to the exemption applications that supports a *lessening* of the regulation that has supported this nascent and precarious emerging competition.

The CCC believes that the draft decision in relation to this exemption application and the draft decision in relation to the WLR/LCS indicative prices released in the same week reflect an emerging pattern in which the Commission appears determined to placate Telstra even if it means discounting or ignoring reasoned and powerful arguments from access seekers.

The CCC reminds the Commission that its primary obligation is to act in the long term interest of end users, and to err on the side of caution when considering how changes in regulation will affect those interests. It does not have an obligation to placate Telstra, which has an explicit public campaign to have all telecommunications-specific regulation removed for the benefit of its business interests.

Recent UK and Other Overseas Developments Highlight Poor Commission Logic

The CCC submits that recent developments in the UK serve to illustrate how deeply flawed is the Commission's reasoning in its draft decision. In the UK Ofcom has recently withdrawn regulation requiring the provision of wholesale DSL services in locations

[1] Draft decision at page 4.
[2] Ibid page 5
[3] ibid

where it deems that there is sufficient exchange-based competing investment providing broadband services.

There are fundamentally different conditions pertaining to the wholesale exemption decisions by Ofcom to that of the ACCC. Not least of these differences is that the Ofcom development serves to highlight that the Commission in Australia has failed to regulate wholesale xDSL services, despite repeated competitive failures in that market that have required the Commission to twice intervene in the market through the use of Part XIB of the TPA, and numerous requests from the industry and others for the service to be declared under Part XIC. Wholesale xDSL in Australia is therefore the subject of pseudo-regulation, a situation that the CCC regards as an on going failure of courage on the part of the Commission for which consumers, particularly in regional Australia, continue to pay a price.

Important differences between the UK approach and the flawed draft proposal from the ACCC's include:

- Firstly, the exempted service of wholesale broadband in the UK is directly substitutable by the LLU-based broadband that Ofcom looked at in determining if there was sufficient competition to allow for deregulation.
- Secondly, the LLU service which delivers this substitute service is the subject of functional separation from the BT retail and wholesale businesses. Conditions around the LLU, and the subsequent comfort that the regulator can take that the service will continue to be made available on equivalent terms to all participants including BT, have now been in place since 2006 and fundamental changes in market conduct by BT have been observed.
- Finally, Ofcom had to be satisfied that participant had market power in any of the geographic markets it deregulated. The regulator therefore was not only confident that competition had developed but confident that it would continue.

The CCC submits that none of these conditions apply in the markets that are the subject of these deliberations by the ACCC.

The wholesale services being exempted in Australia are not broadband but voice services, for which the ULLS is not a substitute, as discussed above and in previous submissions from the CCC and others.

Telstra does not acquire the ULLS, there is no functional separation of Telstra, and the price terms of conditions of access to the ULLS have been the subject of unresolved dispute and legal challenge for years.

Telstra has vertical and horizontal market power in all communications markets in Australia, a situation that the Commission has proved impotent to address time and again.

As per the Commission's own words extracted above, the Commission has not concluded that there is effective competition for the services proposed for exemption in geographic retail markets. In fact it has explicitly concluded that there is not effective competition.

It is also important to note that the Ofcom decision was endorsed by the European Commission because it concluded that Ofcom had reached its decision to move to geographic deregulation on the basis of detailed economic evidence. There is no such evidence apparent in the ACCC's draft decision. Rather, the ACCC is proposing to take a leap of faith that it can force access seekers, already faced with years of campaigning by Telstra to undermine the basis of their business plans, to invest more capital. Access seekers would presumably be expected to do this in the hope that the Commission will be convinced to support their additional investments against anti-competitive responses from Telstra with the type of strong enforcement action that the Commission has been unwilling to pursue in recent years.

Overseas, there have been some other regulatory experiments with the removal of regulation from some wholesale services on the basis of infrastructure competition. These have been producing very mixed results, even where there is genuine end-to-end infrastructure competition.[4] In both Canada and the US there is increasing concern that the removal of the investment stepping stones in the form of wholesale services, or the failure of the regulatory regime to keep up with incumbent actions designed to neutralize the effectiveness of some stepping stones, are resulting in declining competition and declining relative broadband performance.

Commission Cannot be Satisfied that the LTIE Standard is Met Given Riskiness of the Decision

In the absence of infrastructure-based competition, the level of risk associated with the proposed exemption approach by the ACCC in Australia is manifestly greater than previous exemptions for regulated services, such as on various transmission routes.

The ACCC says competition for voice services has not developed as it would like. The Commission assumes that the removal of wholesale services will lead to the entry of alternative providers. There is no evidence that this will be the reaction of those presently in the market. There are, however, factors that raise serious doubts as to whether this would be the market response.

For example, does the Commission really believe that market entry promoting competition will appear in order to offer products at the wholesale level to rival WLR and

[4] Canada's Global Edge in Broadband Dwindling
http://www.cbc.ca/technology/story/2008/05/20/tech-broadband.html
"Is the U.S. Dancing to a Different Drummer?", Communications & Strategies, no. 60, 4th quarter 2005. http://www.idate.fr/fic/revue_telech/132/CS60%20MARCUS.pdf.Scott Marcus Paper

LCS when the very exchanges that would be need are soon to be de-commissioned due to the roll out of FTTx? That is, the stranding of existing DSLAM is of real concern to the business plans of Telstra's infrastructure based competitors yet the Commission, without empirical evidence, presumes further "lemming like" investment will occur notwithstanding FTTN.

Indeed, even without the potentially catastrophic impact of FTTN, it is understood that the response by some competitors to recent increases in the price of wholesale voice services has lead them to withdraw from markets where they were reliant on wholesale services, rather than investing more (see below).

The legal standard that the Commission must apply is that it must be positively of the view that the acceptance of the exemption will be in the LTIE[5]. Given the many aspects of this decision that would be untried, unproven and reliant on conjecture about the response of various participants in the market, it cannot be satisfied that this test is met.

The only reason the Commission could be considering taking such a risk with the LTIE is if it has subscribed to a philosophical position that would represent a fundamental departure from the approach it has taken in the past. If it wishes to do this it should explicitly state that this is going to be its approach. The Commission refrained from reaching this conclusion in its strategic review papers. It should declare explicitly if it has decided to move from the stepping stones principle so that market participants have the option of withdrawing from markets where their reliance on their understanding of the Commission's approach to date would now leave them exposed, or to allow them to refer this change of heart by the Commission to policy makers such that this change can be properly examined to consider if it is consistent with the intention of Parliament.

It is, however, entirely inappropriate for the Commission to apply a new regulatory approach in an ad hoc manner based on representations from Telstra.

Not dealt with in the draft decision – LTIE test questions

The Commission has not explained how it has considered the following representations made in a submission from Nicholls Legal on behalf of the CCC.

Subsection 152AT(4) requires the ACCC not merely to have regard to whether certain requirements have or have not been satisfied, but requires the ACCC not to make the exemptions orders *unless* it is so satisfied. This in turn means the evidentiary burden to be overcome in order satisfy the test is very high. In the "Telstra LSS case" the ACT took the approach that the ACCC "must not accept" an access undertaking unless it was

[5] Nicholls Legal Submission on Behalf of the CCC. http://www.accc.gov.au/content/item.phtml?itemId=807661&nodeId=81047614dee994cec1bd79eecf634b4b&fn=CCC%20submission%20to%20all%20%20Telstra%20declaration%20exemptions%20(March%2008).pdf

"affirmatively satisfied" that the criteria had been satisfied. It is therefore not merely a matter of being satisfied on the balance of probabilities, but requires the ACCC to be satisfied to a very high degree of certainty before making the exemption orders.

The test is a strict test, rather than a discretionary one. Therefore the Commission must be satisfied that the exemption sought *will* promote the LTIE. This further requires the ACCC to be satisfied to a very high degree of certainty, as opposed to it merely being satisfied that the exemption sought "may" or "is likely to" promote the LTIE.

Telstra bears the onus of proving that the test has been satisfied; however much of the so-called evidence provided by Telstra in support of its Exemption Applications is not evidence at all, but merely speculation. Telstra posits in its submissions in support of the Exemption Application that the exemptions sought could, in certain circumstances, or at some point in time, promote competition and efficiency in the abstract; this is far short of the requirement that the exemptions *will*, with certainty, promote the LTIE.

Question should be: *will the competitive environment for fixed-line voice telephony services be better with or without Telstra being required to supply WLR/LCS in the relevant ESAs*? Telstra argues that the presence of at least one competitor's DSLAM (or multiple) equates to "workable competition" - an overly simplistic approach. Workable competition is not simply a function of furthering the particular type or number of competitors. The aim is to ensure the existence of the conditions necessary to promote effective competition. The benefits that result from the process of competition = lower prices and the displacement of inefficient suppliers by efficient suppliers of services. (Sydney Airport case, Telstra ULLS case & Services Sydney case).

Uncertainty – Further Questions about the Ability to Satisfy the LTIE Test

Even if the Commission does not believe that the LTIE test standard is higher in the case of an application for an exemption from regulation, the CCC submits that the Commission cannot be satisfied that the exemption is in the LTIE.

How is the ACCC able to determine the ***long-term*** effects of granting the exemption in the current climate of uncertainty, and when the following matters are "unknown"?

1. The nature of wholesale and retail services on the FTTN in the affected ESAs.
2. The pricing of services to be available on the NBN in the affected ESAs.
3. The non-price issues involving the rollout of the NBN in the affected ESAs and how this impacts any possibility for on-going DSLAM investments.

Accordingly, how is a regulator able to make a decision to rollback access regulation given the climate of uncertainty? How is "long-term" defined (see top p: 7)? There is little evidence to support a contention that there will be ***any*** increased ULLS-based voice service competition in the current (and foreseeable) climate.

Promotion of Competition

In what way has the ACCC investigated the ability of entrants to compete with Telstra in the noted markets? Are the addressable customer numbers relevant or appropriate? ACCC acknowledges Telstra's market power at the wholesale level (p: 62) and agrees that there are significant barriers to entry at the wholesale level, yet it nevertheless deems less regulation as the approach to increase competition in the downstream retail market. This does not follow given:

1. The uncertainty around ongoing ULLS based competition (see above).
2. Telstra's ongoing attack on ULLS rates and recent non-price anti-competitive conduct (the capping of exchanges).
3. Stalling the move from LSS to ULLS based competition (see p: 41).
4. The fundamental quality difference (especially in business markets) between ULLS based voice and LCS quality of service. Indeed, ACCC adopts the Telstra position that "there are no technical constraints" that prevent DSLAM based services being as good quality of service to LCS. This is not supported by the facts, especially in the corporate market.

Markets adversely impacted by exemption – bundling

Retail services are increasingly acquired in a "bundle" that often includes line rental/fixed voice/internet/mobile/pay TV. Regulation at the wholesale level that mandates access to some of these inputs to the retail offerings (e.g. WLR and LCS) allows those with but one of the bundled retail services to better compete with the fully integrated offerings of Telstra. Without access to the LCS and WLR, there will be less competitive bundled Internet/voice offerings and fixed/mobile offerings. There is no evidence in the Commission's discussion paper that can provide any confidence that alternative wholesale supply of these services will be made available should Telstra choose to withdraw access to wholesale WLR/LCS services. This in turn will impact competition in a variety of wholesale and retail markets.

Market structures

Looking at the factors that are relevant in the ACCC's competition assessment (at page 46, 47), it is impossible to understand how the ACCC has decided that the relevant markets are "effectively competitive". At page 49: "The ACCC has calculated that access seekers using ULLS have on average a 6% share of the total SIOs in the proposed exemption areas".

Further, the few examples of where wholesale competition might have emerged are pathetic in scale and irrelevant in the face of ACCC comments about Telstra's market

power (see p: 62, 63). Yet the Commission determines granting the exemption will increase wholesale competition (at p: 70).

Asset Stranding

At p: 54, the ACCC argues that a rush of DSLAM investments in the short period between now and the NBN rollout is an efficient outcome because it would enable those that have the DSLAMs to have enhanced offerings and reputations that they would leverage into improved positions on the NBN. This is evidence of a regulator out of touch with capital market reality. It is a piece of speculation about the reasoning of market entrants with which no member of the CCC concurs.

Exiting the market

The Commission's acknowledgement that there will be some who might exit the market means the Commission is gambling that removing the stepping stones will force competition to develop. This is huge risk for the Commission to take. It is in effect explicitly willing to accept greater concentration in telecommunications markets in some locations. There is a real risk that this concentration will not be geographical confined but will be part of a general increase in concentration on the supply side. The Commission should have learnt from its experience in the increasing concentration of supply in grocery and petrol markets. The Commission has presided over developments in those markets that have clearly been detrimental to consumers and have now forced Government intervention to attempt to stimulate competition.

Possible Responses of Competitors and Addressable Markets

The ACCC assumes that removing access to wholesale services will force access seekers to increase investment in order to provide alternative voice services. It is at least equally likely that access seekers will simply stop providing services where wholesale services are removed and there are barriers to entry for alternative services, concentrating on areas and markets where they are more secure in their confidence about their investments. There is evidence to support this in the decisions by some access seekers to respond to increases in prices for wholesale voice services by simply no longer competing for those customers[6]

Conditions around the exemption are unsatisfactory

Many unknowns arise in relation to the market in 12 months time so delaying implementation until then merely facilitates a raft of unintended outcomes. Timing and transition problems arising from the draft decision include:

[6] Modest lift as Optus holds calls. The Age February 6 2008

- A twelve months transition period is, for example, inconsistent with contract lengths for most corporate customers – so absent certainty of supply, how can new customers be acquired?

- The Commission has "parked" arbitrations in relation to various ULLS disputes. These arbitrations are the only mechanism that the CCC can see that will explicitly deal with the many bilateral non-price access issues that have arisen and continue to arise in relation to the ULLS (see below). This means the Commission will be unable to resolve non-price access issues in 12 months.

- The ULLS declaration has 14 months to run. There is no certainty that this service will continue to be available or will not be transformed in some important way, given the recent history of unpredictable decision-making from the Commission. Telstra also has on foot challenges to ULLS regulation, part of an unrelenting campaign of attack on this service that further undermines investment decisions around ongoing, yet alone increased, ULLS-based investments. It is nonetheless these investments that the ACCC hangs its decision on and which it claims it will promote competition.

- Access services to allow competition over an NBN will be wholesale, based on what has been reported to date. The transition from ULLS to this is likely to be far more disruptive than transition from WLR/LCS.

- Sub-loop unbundling has been parked because of Commission argument that the NBN process will overtake it. How is this different? This double standard by the Commission gives rise to a clear implication that the only difference is that the Commission has decided to favor Telstra's interests over those of access seekers. It proposes going ahead with a process to deliver a change that Telstra wants while putting aside a far less radical proposal from access seekers.

The Commission is choosing to set two precedents that are departures from past practice that warrant far more examination – first time the Commission has exempted a declaration where there was not end to end infrastructure competition (it has called ULLS "quasi-infrastructure competition" in the past) and the first time it has removed a declaration when it says there is not effective competition. In effect, the Commission is saying it is removing the stepping stones to force competition to develop, which is a profound philosophical departure from past practice.

It should be noted that in the context of service providers wishing to migrate to ULLS, the migration process has been marked by Telstra's tactics in delaying the deployment of competitive infrastructure through imposing time consuming and blatantly anticompetitive deployment processes, and more recently, through blocking access to exchanges (capping).

In regard to this, it is notable that the exchange access process will need to be revised and rewritten before the ACCC should place any reliance on access seekers achieving fair, reasonable and efficient access to deploy exchange based infrastructure. Equally concerning however, there is no compelling evidence put forward by the ACCC in its draft decision to demonstrate that granting the exemptions would lead to infrastructure investment that could be considered a more efficient outcome than what has presently evolved.

Addressable markets and "lost" end users

The Commission's discusses about the size of addressable markets in terms of the number of end users available from exchanges. However, it does not consider what the impact of the exemption would be on those end users that are precluded from acquiring a ULLS-based competitive service in these exchange areas. These would include customers whose lines fail qualification tests to be transferred to a competitor, such as those on RIM of a pair gain, both of which are technologies Telstra has installed in its network, and long line copper access to some households. The CCC understands that access seekers are experiencing line service qualification test failure rates in excess of 20 percent in some exchange areas.

Are consumers who suffer from such a situation who happen to be in an exempted exchange area now to be left in a situation where they are no longer able to access any competitive service, not even a regulated wholesale service? Granting the exemption, as proposed will, ultimately, eliminate competition in respect to a significant proportion of end-users that cannot be serviced by ULLS. This clearly cannot be in the long term interest of end-users

Vertical Market Power and Sustainable Competition – Transmission

In reaching its draft decision the ACCC appears to have given insufficient regard to Telstra's market power in respect to transmission routes. The viability of ULLS based delivery of services is severely compromised in some of the named ESA's because of the high price of transmission, and uncertainty around future pricing. The ACCC should not make any decision on removal of declaration in relation to any of the proposed ESA's until it has finalised its transmission cost model, and determined indicative prices. In the absence of this security, service providers are not in a position to properly assess the viability of ULLS based services with confidence that transmission pricing will not make the services unprofitable in future.

Conclusion

It is inconceivable that granting the exemptions as proposed could be said to be sure to lead to a more competitive retail market. It is clearly apparent the ACCC has unduly belittled competition based on accessing the WLR service, adopting an artificially narrow approach to the concept of competition and the interests of end-users. While the

environment for competition could obviously be improved, the ACCC should not disregard the fact that delivery of services using Telstra's WLR service does give rise to choice of service providers, and also gives rise to significant scope for those service providers to differentiate and innovate. Customers value the choice of service providers, and more particularly, make purchase decisions based on factors such as customer service, account management, trustworthiness of the brand and fault handling reputation.

In reaching conclusions about the benefits to consumers the ACCC appears to disregard the competitive potential of WLR based services, and also disregard the real prospect that removal of the declaration in these ESA's in the current environment has the potential to eliminate this form of competition and consequently could lead to a substantial lessening of competition.

In reaching its draft decision the ACCC has mistakenly concluded that removal of access to the WLR/LCS would lead to a more efficient outcome in encouraging additional investment in ULLS infrastructure. Indeed, the ACCC makes a finding that the on-going regulation of WLR/LCS may hinder the extent and speed of transition to ULLS based services. This finding does not reflect the experience and advice to the Commission of access seekers and is clearly erroneous. Whilst removing the declaration as proposed may force some additional migration to ULLS, there is no evidence to suggest that will be a more efficient outcome. There is, however, evidence to suggest that there are other barriers to the progress by access seekers further along the ladder of investment. That the Commission has treated these issues with such caution will demonstrating a willingness to take a regulatory leap of faith to satisfy demands from Telstra reflects a serious failure of perspective on the part of the Commission.