Supplementary submission in response to ACCC Discussion Paper

Fixed Line Services Final Access Determination – Primary prices

PUBLIC VERSION

October 2014

Section 1. Overview

1.1 This submission provides some initial comments on material lodged by Telstra in response to the ACCC's fixed line FAD Discussion Paper. The material lodged by Telstra seeks to reframe the debate away from the promotion of competition towards issues of cost recovery and Telstra's claim for increased access charges.

1.2 Optus wishes to highlight and address key issues in the Telstra submission. The issues are:

(a) Telstra argues that it will be disadvantaged unless the current fixed line access prices are increased. This claim is not supported by market realities. Telstra remains one of the most dominant and highly integrated incumbent players globally; Australia has some of the highest access prices in the world; and Telstra has EBITDA margins that are well above those of its global peers.

(b) Telstra argues that without adjustments to take into account falling demand in fixed line services it will be unable to recovers it costs. This is the same argument put forward in the 2011 FAD Inquiry. Actual market evidence shows that since that time, Telstra has increased PSTN EBITDA margins and increased its overall profit.

(c) Telstra claims that it will lose revenue and margin because of the transition to the NBN. However, these claims fail to acknowledge that the migration payments Telstra will receive from NBN are specifically designed to offset any negative impact from the transition to the NBN. Telstra 's claims are contrary to:

(i) statements made by Telstra's Senior Management that NBN disconnection payments offset any market share loss and margin erosion in Telstra's fixed line business; and

(ii) the ACCC's conclusion in 2011 that Telstra would be compensated twice if fixed line access prices were adjusted for declining market share.ee

(d) Telstra relies upon the approach to regulation of energy markets. Whilst this has some relevance, there are important differences between electricity and telecommunications regulation. Regulation of electricity focuses on the principles of efficient investment. By contrast telecommunications regulation under Part XIC is based on the broader objective of promoting competition.

1.3 Optus expands on each of these issues in greater detail below.

Section 2. Response to Telstra's claims

2.1 This section addresses claims made by the Telstra in its submission in response to the fixed line FAD Discussion Paper. These are:

(a) Telstra will be disadvantaged unless the current fixed line access prices are increased;

(b) Losses due to NBN migration need to be recovered from access seekers;

(c) Telstra's reliance on the approach to regulation of energy markets; and

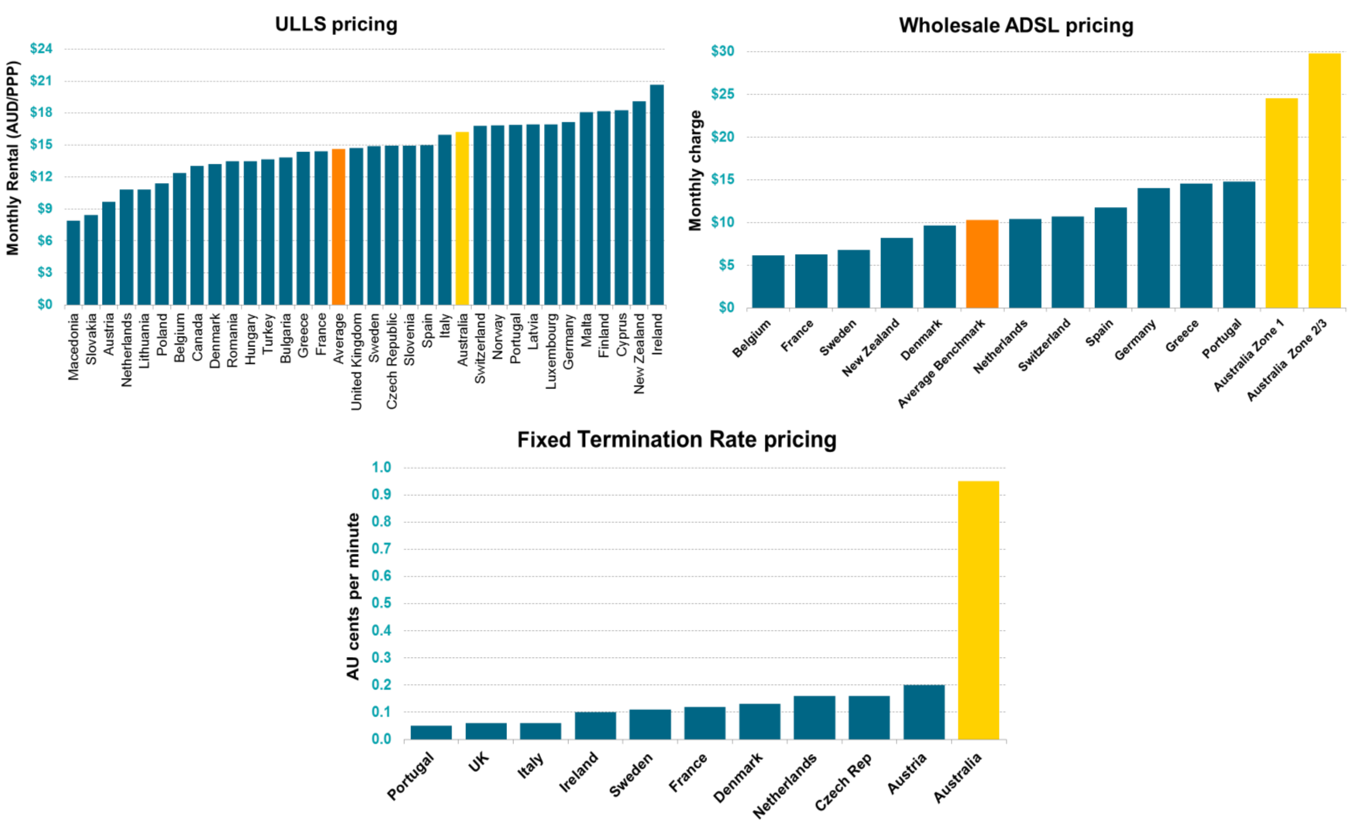
(d) Telstra's reliance on the assumption that it self-supplies regulated wholesale products.

Telstra has not been disadvantaged by fixed line access prices

2.2 Telstra submits that absent a 7.2% increase in regulated access prices it would be unable to recover its costs, and would have little incentive to invest in the fixed line network. Such a view does not reflect the reality of Telstra's position in the market.

2.3 First, Australia has some of the highest regulated access prices across comparable countries. Australia has the highest monthly charge for wholesale ADSL; ULLS pricing is substantially greater than the average; and fixed termination rates are nearly eight times higher than the efficient level. Claims that Telstra has been subject to unfairly low regulated rates are not consistent with observable facts.

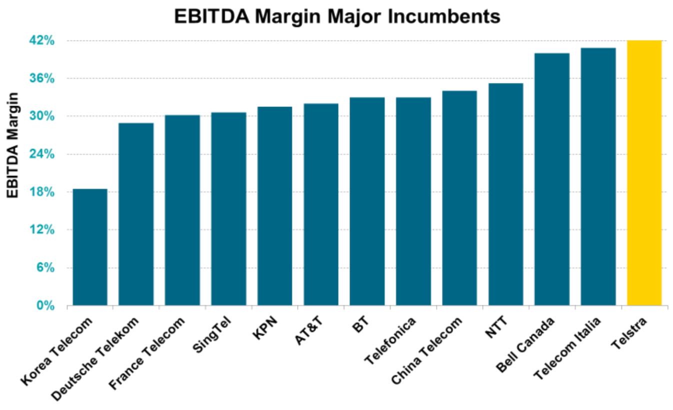
Figure 1 Regulated Fixed Line Prices



Source: National Regulatory Authorities, NZCC

2.4 Second, claims that ‘low’ regulated rates have had a negative impact on Telstra’s profitability are also not consistent with observable market data. An analysis of recent annual reports for the major incumbent telecom operators around the world show that Telstra has the highest EBITDA margin. To suggest that the pricing regime under Part XIC has caused Telstra financial hardship is not justified.

Figure 2 EBITDA Margins of Global Incumbents

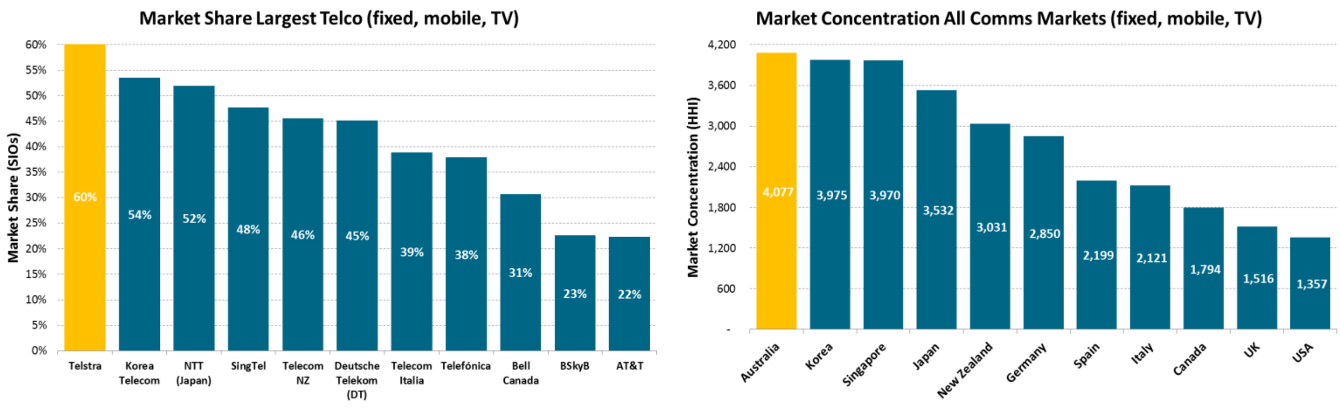


Source: Company Annual Reports

2.5 Third, Telstra’s level of vertical and horizontal integration is significant. It is unusual in owning networks across fixed, mobile and subscription TV platforms. It is therefore not surprising, that Telstra is also the most dominant incumbent across comparable markets. Telstra has a dominant position in fixed broadband, fixed voice, mobile and subscription TV. It has a combined market share across these four communications market of 60%; and the Australian combined communications market is the most concentrated across comparable markets. The lack of competition in the Australian market can be compared to the UK and the USA, which has applied structural remedies to incumbent operators and have competitive non-integrated subscription TV markets.

2.6 The objective of Part XIC is to promote the long term interest of end-users (LTIE) by promoting competition and efficient investment in, and use of, infrastructure. It is failing to do this. It is false for Telstra to claim that fixed line access prices are having a detrimental impact on its financial or market position.

Figure 3 Total Communications Markets



Source: Company Annual Reports, Merrill Lynch

2.7 Finally, Telstra puts forward the view that price decreases will have a detrimental impact on end-users and that price increases are beneficial.[1] This view is repeated in its advisor's opinion that competition in other markets would decline because the competition provided by Telstra would be less if it were required to recover fixed line loses in other market.[2]

2.8 This is a novel interpretation of promoting competition. Typically one expects the benefits of competition to be lower prices for consumers and displacement of inefficient suppliers by efficient suppliers.[3] Competition is promoted through lower prices approaching marginal cost – promoting competitive entry of alternative providers and the additional competitive pressure to reduce costs over time. The view that price competition comes from the pricing of the incumbent is not widely accepted. Actual Australian market data show that Telstra is not the source of price competition in the mobile or fixed market – it has constantly had a significant price premium.

2.9 Telstra also sees competition for end-users during the transition to NBN as a detriment – Telstra calls this intra-migration and views it is detracting from the LTIE.[4] Lower access prices would encourage end-users to shift away from Telstra to lower priced alternative providers. Telstra is essentially arguing that the roll of access pricing is to ensure that the dominant incumbent maintains its current dominant market share during transition to NBN. This would result in the transfer of legacy market problems to the NBN, thereby undermining the purpose of structural remedies. This is not in the LTIE, and no reasonable assessment can come to this conclusion.

Partial allocation method has not caused financial harm

2.10 Telstra puts the argument that the partial allocation method prevents it from recovering the costs of providing fixed line services.[5] This is a repeat of claims put forward in its submissions during the 2011 FAD Inquiry.[6] The ACCC rejected these claims in the 2011 FAD. It is therefore instructive to test whether Telstra's 2011 claim was correct during the last regulatory period. If Telstra's claims in 2014 are correct, then Telstra must have suffered financial harm during the last regulatory period.

2.11 It is correct to state that if the 2011 FAD adopted Telstra's proposal, it would have received higher revenue from fixed line services. But the objective of Part XIC is not to maximise Telstra's revenue. Rather, it is to promote competition subject to the legitimate business interests of Telstra and its direct costs of provision. It is therefore instructive to see whether Telstra has been unable to recover its operating costs, cost of infrastructure, and make a normal rate of return.[7]

2.12 Was Telstra able to recover PSTN-related operating costs during a period of declining demand and under the 2011 FAD allocation method? Telstra's Annual Reports clearly shows that it has – while Telstra faced an 18% decline in average annual PSTN revenue over the regulated period,[8] it has reduced its average operating costs by 21%. As a result, Telstra has increased its EBITDA margin from 59% in 2011 to an average of 61% over the last regulatory period.

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[1] Telstra, 2014, Public inquiry into final access determinations for fixed line services – primary prices, Response to Discussion Paper, 3 October p.7
[2] Incenta, Cost allocation for fixed line services, October, p.23
[3] Re Telstra Corporation Ltd (No 3) [2007] ACompT 3 (17 May 2007), [98-9]
[4] Telstra, 2014, Public inquiry into final access determinations for fixed line services – primary prices, Response to Discussion Paper, 3 October p.8
[5] Telstra, 2014, Public inquiry into final access determinations for fixed line services – primary prices, Response to Discussion Paper, 3 October p.102
6 Telstra, 2011, Part A of Telstra's response to the Commission's Discussion Paper, Section 1.2
7 Re Telstra Corporation Limited (ACN 051 775 556) [2006] ACompT 4, [89]
8 Average PSTN revenue for years ending 2012, 2013, 2014.

2.13 There is no evidence that the approach adopted in the 2011 FAD has resulted in Telstra being unable to recover its costs of operation, or unable to make an adequate return.

2.14 Telstra is a multi-product firm, where only 6% of its revenue relates to regulated fixed line services. Multi-product firms are able to shift costs and revenues across regulated and non-regulated products in order to maximise overall profit.[9] While it is more difficult to disaggregate overall capital costs, the relevant question is whether Telstra has been unable, as a whole, to recover its regulated-related infrastructure costs.

2.15 The following data points indicate that Telstra has been able to recover the costs of its infrastructure over the last regulatory period. Average annual EBITDA has increased over the regulatory period by 3.6%, and average annual EBIT has increased by 11.8%. The increase in EBIT has occurred over the period where Telstra's annual capex has increased from $3.4b in 2011 to $3.7 in 2014; and its free cash flow has increased from $5.5b in 2011 to $7.5b in 2014.

2.16 There is no evidence to support the claim that Telstra has been unable to recover its infrastructure costs during the last regulatory period. Therefore, the use of the partial allocation method in the 2011 FAD was consistent with the legitimate business interests of Telstra. The partial allocation method should continue in the next FAD.

Market share losses are compensated through disconnection payments

2.17 The central theme of Telstra's submission is that it must be compensated for the loss of value, or increased cost, associated with the loss of fixed line users, primarily due to the migration of end-users to NBN. Telstra proposes to do this through changes to the allocation method in the FLSM, which results in an increase in access charges. Telstra states this will offset the loss of fixed line earnings and free cash flow.[10]

2.18 However, the PSAA disconnection payments received from NBN Co already compensate Telstra for loss in market share due to migration to NBN. David Thodey, CEO of Telstra, made clear that "*the payments to be received are to offset both any market share loss and any margin erosion in Telstra's fixed line business*".[11] As a result, Mr Thodey did not expect to see any revenue loss as a result of migration to NBN:

> *While we may see some margin dilution in an NBN world, we are confident in our ability to continue to grow our revenues in mobiles, media and network applications and services and that* ***growth plus payments received as part of the deal will offset any NBN-related retail and wholesale revenue losses****.*[12] [emphasis added]

2.19 This view was again emphasised by the CFO, Mr John Stanhope, who described the disconnection payments as being NBN Co's "*consideration to [Telstra] for anticipated share and margin dilution in our fixed line business*".[13] He continued to explain that the payments protect Telstra from the impact of competition:

[9] See comments in Re Optus Mobile Pty Limited & Optus Networks Pty Limited [2006] ACompT 8 [101]: *"a multi-product firm, in an unregulated, effectively competitive market, [can price] its individual products however it chooses (subject to prohibitions on anti-competitive conduct), even to the point of selling a product at below cost if it believes this is conducive to maximising its overall profit."*

[10] Telstra, 2011, Explanatory Memorandum for the Resolution Under Item 2
at the Annual General Meeting on 18 October 2011: Telstra's Participation In The Rollout Of The National Broadband Network, p.9

[11] Telstra, Transcript of Conference Call: Telstra signs Definitive Agreements, 23 June 2011, p.8

[12] Telstra, Transcript of Conference Call: Telstra signs Definitive Agreements, 23 June 2011, p.9

[13] Telstra, Transcript of Conference Call: Telstra signs Definitive Agreements, 23 June 2011, p.21

So put another way, that $4 billion is expected to replace any share loss in fixed line and any margin dilution. Why do we think there'll be some share loss? Of course there is a disruptive event about to occur. Every home in Australia will, over 10 years, get a doorknock that says have I got a deal, come with me, I'm a great retail service provider. ***So we've protected ourselves from that possibility****.*[14] [emphasis added]

2.20 There is clear evidence, at the time agreement was announced, that the purpose of the disconnection payments was to make Telstra whole and compensate for losses associated with migration to NBN. It is disingenuous of Telstra to claim that fixed line access charges should change to compensate for the same loss.

2.21 Optus repeats its observation that this issue was dealt with in the 2011 FAD Final Report, which concluded:

The ACCC considers that ***Telstra would be compensated twice*** *if any compensation of market share were to be allowed in estimating prices for the declared fixed line services.*[15] [emphasis added]

2.22 There has been no material change to the facts put to the ACCC since 2011 on this issue. There is therefore, no material on which to alter the conclusion.

2.23 Optus recognises that there remains an issue as to how to take into account loss in market share due to competition and migration to mobile services. But, as already observed in 2011, a firm operating in a competitive market cannot respond to declining market share by increasing prices as this reduces its ability to compete with alternative suppliers.[16] It is clear that the legitimate business interest of access providers does not extend to allowing prices higher than that would be seen in a competitive market, since no business has a right to revenues higher than those obtainable in a competitive market.[17]

2.24 Furthermore, it is clear that the legislative provisions in Part XIC relating to 'legitimate interests' and 'direct costs' were inserted to "*preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market*."[18] It was never the intention of the telecommunications access regime to allow the monopoly provider of fixed line services to charge higher access prices as a result of losing market share due to competition.

Telecommunications regulation is not the same as electricity or gas

2.25 Telstra and its advisors rely heavily on the regulatory approach in the utilities industries – mainly electricity and gas.[19] There is an implicit assumption that these regimes are the same. While the fixed line services model is based on the same method employed in electricity and gas models, it is not correct to assume the regulatory regimes are the same – the use of the same modelling concept does not mean that Telstra is governed by the national electricity or gas rules.[20] There are significant differences which neither Telstra nor its advisors recognise. These include:

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[14] Telstra, Transcript of Conference Call: Telstra signs Definitive Agreements, 23 June 2011, p.21
[15] ACCC, 2011, FADs for fixed line services, Final Report, p.11
[16] Ibid.
[17] Application by Telstra Corporation Limited ABN 33 051 775 556 [2010] ACompT 1 [192]
[18] Trade Practices Bill 1996, Explanatory Memorandum
[19] See section 2 of its response to the Position Paper, which analyses the Telstra BBM against those which operate in the electricity and gas industries.
[20] Although Telstra does emphasise that it is not like most regulated utilities when the argument is in its favour – see p.45 of its response to the Position Paper.

(a) Telstra is a multi-product firm in which regulated revenue represents a small part of over-all revenue. This can be compared to the role of price setting under the AER which set revenue caps for distribution and transmission network providers – a single product, single network monopoly.

(b) The national electricity objective is to promote efficient investment in, and operation of, electricity infrastructure.[21] This can be compared to the objective of Part XIC, which is to promote the long term interest of end-users through the promotion of competition.[22] Telstra makes little, if any, reference to the impact on competition in related markets.

2.26 The impact is that there is no legislative requirement for access pricing to 'guarantee' that Telstra can recover all its costs. It is long accepted in telecommunications access pricing that the range of reasonable prices fall in a range between marginal cost and stand-alone costs.[23] The role of the ACCC is to set prices which fall within this range and which best promote the LTIE – balancing the need to promote competition and retain incentives to invest. See Appendix A of Optus' submission to the Fixed Line FAD Discussion Paper for a discussion of this trade-off.

2.27 The overall impact of regulated revenue on Telstra's financial position is in any event insignificant. First, fixed voice revenue represents only 16% of total services in FY14, and regulated revenue represents only 6% of revenue.[24] If, for example, regulated revenue fell to zero (and no one is arguing it should), Telstra's EBITDA margin would fall from 42% to only 39% – a level that is still above most of its peers.

2.28 Claims that a failure to adopt a 7.2% adjustment to regulated access pricing would cause Telstra material financial damage are not credible. The objective of Part XIC is not to protect the profit margin of Telstra but to promote competition.

Telstra does not self-supply regulated wholesale products

2.29 Telstra repeatedly claim that the effect of the fixed principles is to share any increase in costs across all end-users of the network – Telstra and access seekers.[25] And that the cost allocation principles seek to ensure no one party bears a disproportionate burden for the recovery of costs.[26]

2.30 For these observations to hold true, an underlying assumption is that Telstra uses its own regulated products to supply retail markets. This is not the case. There is no separation of wholesale and retail; there is no self-supply; or equivalence of inputs test. Telstra made it clear in the Structural Separation Undertaking (SSU) that its equivalence obligation is subject to a number of qualifications which exclude any requirement for Telstra to implement measures which Telstra views as elements of functional separation, including transfer pricing, self-consumption of wholesale regulated services and equivalence of inputs.[27]

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[21] See, *National Electricity (South Australia) Act 1996*, Section 7
[22] Section 152BCA and 152AB of the CCA
[23] See, Vogelsang, I., 2003, 'Price Regulation of Access to Telecommunications Networks', *Journal of Economic Literature*, 41(3): 830-862; Temin, P., 1990, 'Cross Subsidies in the Telephone Network after Divestiture', *Journal of Regulatory Economics* vol. 2 (1990).
[24] Telstra, 2013, Final Access Determinations Inquiry – Public response to information request under the BBM RKR, 25 November, p.6
[25] Telstra, 2014, Public inquiry into final access determinations for fixed line services – primary prices, Response to Discussion Paper, 3 October, p.31
[26] Telstra, 2014, Public inquiry into final access determinations for fixed line services – primary prices, Response to Discussion Paper, 3 October, p.6
[27] SSU, clause 9(b). See also ACCC, Final Decision, p.71

2.31 Telstra faces the marginal network cost to supply retail services. This can be compared to the fully allocated cost attributed to access seekers. Telstra, by the nature of its vertical integration, faces significant cost advantages when competing in retail markets. Any increase in the regulated access charges are not reflected in increased network charges incurred by Telstra Retail. This reality is confirmed by recent comments by Mr Thodey that increases in wholesale prices do not have to flow through to Telstra retail pricing.[28]

2.32 The impact is that Telstra faces marginal cost to supply, while access seekers will face 7.2% increase. Telstra Retail does not need to increase its charges, but competing retail suppliers using Telstra wholesale services will have to. This is classic margin squeeze behaviour and does not promote competition.

[28] "Fixed phone customers won't pay more", 22 October 2014, http://www.morgans.com.au/research-and-markets/market-news-and-data/Breaking-News/Fixed-phone-customers-wont-pay-more-S-1298122