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REPORT

**EXPERT REPORT BY DR
PAUL PATERSON OF
CONCEPT ECONOMICS FOR
MALLESONS STEPHEN
JAQUES ON THE ACCC
DRAFT DECISION,
'TELSTRA'S PSTN
ORIGINATING ACCESS
EXEMPTION APPLICATIONS'**

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26 September 2008

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RE: EXPERT REPORT BY DR PAUL PATERSON OF CONCEPT ECONOMICS FOR MALLESONS STEPHEN JAQUES ON THE ACCC DRAFT DECISION AND PROPOSED CLASS EXEMPTION, 'PSTN ORIGINATING ACCESS', SEPTEMBER 2008

Please find enclosed the final Expert Report on the ACCC draft decision on PSTN OA as outlined above.

Yours sincerely



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1. INTRODUCTION

My name is Dr Paul Paterson. I am employed in a senior role as an economist with Concept Economics, an Australian-based economic consulting firm. My curriculum vitae, including qualifications, experience and publications, is included in Appendix B.

On 5 September 2008 the Australian Competition and Consumer Commission ('the Commission') released a draft decision in relation to Telstra's PSTN originating access ('PSTN OA') exemption applications ('Draft Decision'), proposing ordinary and class exemption in certain ESAs subject to certain conditions.¹

I have been asked by Telstra, through the offices of Mallesons Stephen Jaques ('MSJ'), to provide an expert report on the economic issues raised by this draft decision, in the context of the long term interests of end users (LTIE) focus required. My instructions from MSJ are reproduced in Appendix A. These instructions indicate that my report is to be prepared with regard to the Federal Court's 'Guidelines for Expert Witnesses and Proceedings in the Federal Court of Australia', which I have done. I note from these Guidelines that my overriding responsibility as an expert witness is to be of assistance to the body charged with considering the matter at hand (the Commission in the first instance).

Prior to the preparation of the current report, I prepared for MSJ three earlier expert reports relating to Telstra's PSTN OA exemption applications:

- My original report ('original report') on this matter, in which I address in detail the question of whether the Exemption Orders sought by Telstra for PSTN OA would be in the LTIE;²
- A supplementary report ('supplementary report'), in which I address specific issues raised by the Commission in its Discussion Paper;³ and
- A supplementary report addressing issues raised in industry submissions to the Commission's August 2007 Discussion Paper⁴

In responding to my instructions, I believe that I can be of most assistance to the Commission by identifying some of the key economic issues raised in the Draft Decision and assessing the approach taken to these issues with regard to whether they have economic merit and whether they lead me to change my previously espoused views.

¹ ACCC, "Telstra's PSTN originating access exemption applications – CBD and metro areas", Draft decision and proposed class exemption, September 2008 ('Draft Decision').

² Telstra, "Statement by Dr Paul Paterson of CRA International for Mallesons Stephen Jaques on the Economic Considerations for a PSTN Originating Access Exemption", Annexure A to "Telstra's PSTN Originating Access Exemption Application – Supporting Submission", October 2007.

³ Telstra, "Supplementary Statement by Dr Paul Paterson of CRA International for Mallesons Stephen Jaques on the Economic Considerations for the domestic PSTN originating access exemption", annexure to "Telstra Response to Questions from ACCC Discussion Paper of October 2007", December 2007.

⁴ Telstra, "Expert report by Dr Paul Paterson of Concept Economics for Mallesons Stephen Jaques on the responses to the ACCC Discussion Paper 'Telstra's domestic PSTN originating access service exemption applications', June 2008



To foreshadow my conclusions, I agree with the general approach taken by the Commission to the assessment of competition and the identification of circumstances in which exemption is likely to be appropriate, although not necessarily its conclusions. However, there are a number of specific issues, in particular on the design of exemption thresholds and conditions, on which my opinion differs from that of the Commission. On these issues I have carefully considered the Commission's arguments but have not found reason to change my opinion.

This remainder of this report is structured as follows:

- In section 2 I express some overarching views on the Draft Decision;
- In section 3 I assess the Commission's approach to determining the impact of exemption on competition and efficient infrastructure investment and use;
- In section 4 I discuss the specific issue of the exemption threshold;
- In section 5 I consider the proposed conditions on exemption;
- In section 6 I consider the implications of the proposed exemptions and conditions for CBD areas specifically; and
- In section 7 I conclude by considering whether any of the Commission's arguments persuade me to change my previously stated opinions.

2. OVERARCHING VIEWS

I have opined in previous reports that the PSTN OA exemptions proposed by Telstra are likely to stimulate efficient competition, promote efficient use of existing infrastructure as well as boosting infrastructure investment and ultimately be in the interests of telecommunications consumers. Since barriers to DSLAM-based competition are low in Telstra's proposed exemption area (as demonstrated by access-seeker entry), I expressed the view that withdrawal of PSTN OA regulation will not damage the competitive process. Rather, PSTN OA exemption will stimulate efficient competition by promoting greater use of DSLAM infrastructure and avoid the inevitable costs of regulation, consequently boosting facilities-based competition. I also note the very substantial degree of fibre-based competitive overbuild in CBD areas as well as low barriers to DSLAM deployment, meaning that the case for exemption is even more compelling for CBD ESAs.

My views on this issue are unchanged and I still consider the exemptions as proposed by Telstra to be beneficial to consumers. Nonetheless, while the Commission has not adopted Telstra's proposal in its Draft Decision, I do consider the Commission's proposed exemption to be a step in the right direction. Withdrawal of PSTN OA regulation as proposed by the Commission is likely to deliver end-user benefits by providing a basis for the growth of facilities-based competition. Moreover, the proposed exemption allows for costly regulation to be lifted in areas where the Commission believes DSLAM-based competition is viable and resale regulation is no longer required.

However, in my view the Commission's proposed exemption is overly conservative and risks unnecessarily limiting the benefits of exemption to particular geographic areas. Since it has been demonstrated by the entry of at least one DSLAM-based competitor that barriers to DSLAM-based competition are low across Telstra's entire proposed exemption area, it is in my view unnecessary to limit exemption to a subset of this area.

It would appear that, in limiting the exemption area to ESAs with four ULLS-based competitors (or a corresponding addressable market), the Commission has decided to withdraw PSTN OA regulation only where deeper competition has *actually* emerged. The Commission's view is that:

This level of ULLS-based entry will provide the basis for effective competition in the downstream markets... In addition, the presence of four ULLS competitors (including Telstra) will also provide an effective competitive constraint on Telstra at the wholesale level.

While I agree that the presence of three ULLS-based competitors is likely to be sufficient, although perhaps not necessary, to constrain Telstra's behaviour (particularly in CBD ESAs for which there is a substantial overlay of competing fibre-based infrastructure), I consider this to be too narrow a focus for the exemption inquiry. In my view the Commission's focus should extend to *barriers to competition* rather than simply the current state of competition in the market, since this is likely to be the key factor determining the strength of constraints on Telstra's behaviour. In areas where barriers to competitive entry are low, the incumbent's behaviour will be constrained not only by present competitors, but also by the threat of further entry and competition.⁵

Additionally, I consider the Commission's proposed conditions on exemption (including those on capped and queued ESAs) to be unnecessary in light of the competition assessment. As noted above, the Commission's exemption area has been delineated to include only those ESAs where there has already been sufficient entry to form basis for effective competition. This means that conditions aimed at ESAs for which there is perceived to be barriers to *further* entry are unnecessary.

Moreover, even if further entry is seen as desirable, the Commission's proposed conditions will not be of maximum assistance in achieving this objective. This is because, rather than remedying what ULLS access problems may be seen to exist, the Commission's conditions simply provide access seekers with a regulated alternative to the ULLS. In this respect, the conditions are a second best solution to directly addressing any perceived problems around access to the ULLS.

Finally, I remain of the view that the CBD exchanges are qualitatively different to the other ESAs in Telstra's exemption area, due to the very substantial fibre-based infrastructure overbuild that exists. For these ESAs in particular I believe there is no plausible case for refusing exemption, including refusing exemption on the grounds of the Commission's proposed conditions.

⁵ Stigler GJ *The organization of industry* (Richard D Irwin, 1968); Demsetz, H, 'Barriers to entry', *American Economic Review*, vol. 72, no. 1, March 1982, pp. 47-57

3. ASSESSMENT OF THE DRAFT DECISION

In this section I provide an economic assessment of the Draft Decision with respect to its competition and investment impacts. As a preliminary step, I consider the approach taken to market definition and how this informs the competition assessment.

3.1. MARKET DEFINITION

As I have noted in previous reports on this matter, I consider the relevant market for the purposes of this exemption inquiry to extend beyond long distance calls and encompass all fixed voice services. I come to this conclusion based on consideration of both the demand-side and supply-side substitutes available to stand-alone long distance services.

On the demand side, consumers have shown a strong willingness to take the full bundle of fixed voice services rather than stand-alone long distance.⁶ Similarly on the supply-side, low barriers to supply of the full bundle (particularly over the ULLS) increase the likelihood of substitutability. This implies that any price increase by a hypothetical monopolist supplying long distance services would be unsustainable given the likely responses from both consumers and producers.

In light of my previously espoused views, I endorse the conclusions of the Commission on market definition. In particular, I agree that the relevant market for the purposes of this inquiry should include the full bundle of fixed voice services given consumer preferences and supply-side factors.

One aspect of the Commission's market definition with which I do not agree, however, relates to the substitutability of VoIP. The Commission notes in its Draft Decision that while "POTS emulation" VoIP may be substitutable on the demand side, carrier-grade and application-layer VoIP services will not be.⁷ This leads the Commission to conclude that carrier-grade and application-layer VoIP should be excluded from the relevant market.

In my view carrier-grade VoIP (i.e. that supplied using an Internet Access Device in conjunction with the ULLS or LSS) should be considered in the relevant market given the likelihood of demand-side substitution. The Commission notes in relation to "POTS emulation" VoIP that demand substitution is likely since 'the experience from the consumer's perspective would be identical'.⁸ In my view the same argument applies to carrier-grade VoIP given the strong similarities in the consumer experience between this and a POTS service. Carrier-grade VoIP allows the consumer to connect a POTS phone to the Internet Access Device and make little change to their calling habits. This contrasts with application-layer VoIP (which I do not consider to be a strong substitute) where calls are made using a different handset or software installed on a computer and the quality of these calls is subject to general internet transmission conditions beyond the control of the service provider or customer.

⁶ As noted in my original report on this matter, the vast majority of lines pre-selected away from Telstra for long distance are Telstra wholesale lines. [c-i-c]

⁷ Draft Decision at pp56-58

⁸ Draft Decision at p57

This substitutability in itself justifies a consideration of LSS-based operators as well as ULLS-based operators, since LSS-based operators may provide a competitive constraint on suppliers of fixed voice services through their ability to provide carrier-grade VoIP. However, the substitutability of carrier-grade VoIP, although in my view relevant and important, need not be determinative, for the following reason.

As noted in my previous reports, the main justification for considering LSS-based and ULLS-based (i.e. DSLAM-based) operators collectively is that it reflects an exemption threshold based on *barriers* to competition, not just the current state of competition. When barriers to this form of competition are being considered, any distinction between ULLS and LSS-based operators is irrelevant, given the similarity of entry barriers faced by each class of competitor.

3.2. COMPETITION IMPACTS

My view on the impact of the exemptions as proposed by Telstra has been that they would promote efficient competition in the market for fixed voice services. Since barriers to DSLAM-based competition are evidently low in Telstra's proposed exemption area, competition will not be diminished by exemption. Rather, it is my view that by removing regulation of a supply alternative, exemption will facilitate efficient DSLAM-based competition.

Whilst it is the strength of this competitive process which is of fundamental relevance in considering LTIE outcomes, the impact of exemption on competitors might also be seen by some parties as worth considering to the extent that it affects the degree of rivalry in the market. In this regard, it has been suggested that PSTN OA exemption may lead to the exit of a number of competitors who rely on this regulation for supply to end-users. However I do not consider this to be a likely outcome for the following reasons:

- First, as noted by the Commission in its Draft Decision, almost all PSTN OA access seekers supply the full bundle of voice services and do not rely on PSTN OA alone;
- Second (and related to the first point), the availability and viability of DSLAM-based supply for this bundle of services in the exemption area means that access seekers would be able to substitute away from resale-based supply in the event of a price increase for PSTN OA;
- Third, given the low barriers to DSLAM-based competition in the exemption area and the anticipated continued proliferation of competitive DSLAM-based supply, it is likely that PSTN OA - or an equivalent service - could be acquired from Telstra and its DSLAM-based competitors absent regulation, to the extent that such supply is efficient (a view also held by the Commission); and
- Fourth, the situation in CBD exchanges is even more obvious with regard to these points, due on the one hand to the apparently low barriers to fibre-based entry, and on the other hand the scope for the several fibre-based operators to provide OA-like services to access seekers.

Finally, it is worth noting that even if exemption does force the exit of some competitors relying only on PSTN OA, this will not significantly affect the competitive process given their *de minimis* market presence.

Hence in many respects I agree with the Commission's assessment of the likely impact on competition of exemption. In particular I share the view that competition will not be diminished by exemption, but rather, enhanced, given the constraints imposed by ULLS-based operators at both the wholesale and retail levels.⁹

Moreover I agree that exemption will promote efficient competition by facilitating a shift away from resale, and towards ULLS-based supply. The Commission notes in its Draft Decision that ongoing resale regulation where it is no longer necessary may hinder this transition.¹⁰

... the ACCC is also mindful that ongoing regulation of the Fixed Voice Bundle may hinder the extent and speed of transition to ULLS-based competition where this supply option may be viable.

Further, the Commission clearly considers ULLS-based competition to be preferable and hence the removal of any hindrances to this form of competition to be in the interests of end-users:¹¹

Increased ULLS-based provision of voice services will promote the LTIE as it will enable competitors to compete in the downstream market on greater dimensions of supply and allow them to dynamically innovate their services, leading to more sustainable competition compared with pure re-sale models in the longer term.

I agree with the Commission on these points. As noted in each of my previous reports, I consider DSLAM-based supply to be a more efficient form of competition with the capacity to deliver enduring benefits to end-users. Moreover, by removing regulation of a resale-based supply alternative where DSLAM-based supply is clearly viable, exemption is likely to assist the transition to ULLS-based competition.

As noted above, I am also in agreement with Commission on the exemption's impact on access seekers currently acquiring PSTN OA. The Commission considers it likely that these access seekers will still be able to acquire wholesale services on similar terms to the current regulated terms, given the constraints on wholesale pricing imposed by the ULLS.¹² Moreover, it is noted that even if some access seekers do exit the market in the event of exemption, any resulting short-term efficiency losses will be outweighed by the long-term benefits of stronger ULLS-based competition.¹³

In short, I am generally in agreement with the Commission on the likely impact of exemption on efficient competition. However, as will be discussed later in this report, it is my view that the Commission's proposed exemption threshold has the effect of unnecessarily limiting these benefits to certain geographic areas (see section 4).

⁹ Draft Decision at p120

¹⁰ Draft Decision at p136

¹¹ Draft Decision at p136

¹² Draft Decision at p120

¹³ Draft Decision at p11

3.3. INFRASTRUCTURE INVESTMENT AND USE IMPACTS

I have opined in previous reports that exemption is likely to both promote efficient use of existing DSLAM infrastructure and boost investment in this infrastructure. The Commission also expresses this view in its Draft Decision, and I am in general in agreement with the points made there.¹⁴ However, while the Commission recognises clearly the scope for more efficient use of, as well as investment in, ULLS-based infrastructure likely to be occasioned by OA exemption, it overlooks the scope for more efficient use of existing fibre-based infrastructure in CBD ESAs with exemption. This point further strengthens the case for exemption of these particular ESAs.

The Commission addresses the issue of stranding of DSLAM investments in the event of a fibre network rollout, in light of the Federal Government's announcement in April of a request for proposals for the construction of a national fibre network.¹⁵ I have not considered this issue in any of my previous reports on this matter, although I have addressed it in response to access seeker submissions on the Commission's LCS/WLR Draft Decision.¹⁶

On this issue I agree with the reasoning and conclusions of the Commission in its PSTN OA Draft Decision. The market evidence presented indicates that access seekers are continuing to roll out DSLAM infrastructure despite the announced request for proposals.¹⁷ This suggests that access seekers see such investments as being in their commercial interests even if a fibre rollout is imminent. I agree with the Commission that this may be because DSLAM-based supply better prepares access seekers for fibre rollout by allowing them to build a reputation and customer base through the ability to provide differentiated products. I also agree with the Commission that this is also likely to reflect the short pay-back period for DSLAM investment, meaning that access seekers will be able to recoup their DSLAM investment reasonably quickly (within 2 years), before fibre is extensively deployed.

¹⁴ Draft Decision at p134

¹⁵ Draft Decision at pp88-92

¹⁶ Telstra, "Expert Report by Dr Paul Paterson of Concept Economics for Mallesons Stephen Jaques on the responses to the ACCC draft decision and proposed class exemption, "Telstra's local carriage service and wholesale line rental exemption applications", July 2008

¹⁷ Draft decision pp88-92. While access seekers have countered that DSLAM roll-out subsequent to NBN developments were already planned, I find it unrealistic that they would necessarily continue with these plans if they thought they may no longer be economic.

4. EXEMPTION THRESHOLDS

I have argued in each of my previous reports that PSTN OA regulation should be withdrawn where barriers to ULLS-based entry and competition are sufficiently low. This implies that the threshold for exemption should identify ESAs in which the barriers to ULLS-based entry are surmountable and there is accordingly the potential for this form of competition.

Whilst evidence of effective ULLS-based competition already occurring in the form of actual DSLAM deployment is sufficient to conclude barriers are low, in my view it is not necessary. Rather, evidence of *any* DSLAM-based entry (i.e. even if effective ULLS-based competition has not yet emerged) is in itself sufficient to demonstrate barriers are low.¹⁸ Thus I consider the presence of one DSLAM-based competitor in an ESA to be an appropriate threshold for exemption since it captures both ESAs in which effective ULLS-based competition is already in place and ESAs where barriers to such competition are low.

In contrast, the Commission's threshold appears to restrict exemption to ESAs in which effective competition has already emerged, rather than allowing exemption in ESAs where the barriers to such competition are low. The Commission notes that four ULLS-based competitors will form the 'basis for effective competition' and impose an effective constraint on Telstra at the wholesale level.¹⁹

While I agree with that the presence of four competitors is likely to be sufficient for effective competition, this does not imply that it is necessary. More significantly, I consider this focus on the level of entry required for effective competition to be inappropriate. In my view the focus of the exemption inquiry should be on *barriers* to ULLS-based competition and where these are sufficiently low. The importance of considering competition barriers rather than making static assessments of competition have been noted by economists²⁰ and courts.²¹ It is these barriers that will ultimately have the greatest impact on market outcomes by constraining the incumbent's behaviour, particularly at the margin.

The Commission has acknowledged that evidence of ULLS-based entry is likely to provide some indication as to the height of barriers to entry. It is noted in the Draft Decision:²²

... evidence of actual ULLS entry is instructive in testing the extent of the barriers to entry such as the addressable market required and access to backhaul and traditional switching infrastructure that may apply in practice for a particular ESA.

¹⁸ Besides, as I have argued in my earlier reports, given the market for fixed voice services has the characteristics of Bertrand competition, it is likely that even one competitor would be sufficient to discipline pricing behaviour. Telstra, "Expert Report by Dr Paul Paterson of Concept Economics for Mallesons Stephen Jaques on the responses to the ACCC Discussion Paper 'Telstra's local carriage service and wholesale line rental exemption applications' August 2007", April 2008, pp17-19

¹⁹ Draft Decision at p167

²⁰ Stigler GJ *The organization of industry* (Richard D Irwin, 1968); Scherer *Industrial Market Structure and Economic Performance*, 2nd ed. (1980)

²¹ The High Court in *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177 notes the importance of entry barriers to firms' behaviour. In particular, the judgement of Mason CJ and Wilson J refers to the writing of Professor Scherer (footnote 20 above) who notes 'significant entry barriers are the sine qua non of monopoly and oligopoly, for ... sellers have little or no enduring power over price when entry barriers are nonexistent'.

²² Draft Decision at p163



I agree with this statement and I would also consider DSLAM-based entry more generally to be a strong indicator of entry barriers (or rather, the lack thereof). On this basis, it is unnecessary to use an exemption threshold as high as that proposed by the Commission.

In short, I consider the Commission's threshold, which requires three ULLS-based competitors to Telstra or a corresponding addressable market, to be overly conservative. In my view this threshold is likely to exclude a number of ESAs where barriers to ULLS-based competition are low and hence unnecessarily limit the benefits of exemption.

Further, the overly conservative exemption threshold proposed by the Commission is not only unnecessary, but will also have the effect of limiting the benefits of exemption to certain geographic areas and imposing unnecessary costs of ongoing regulation in others.

5. CONDITIONS

I have not considered the issue of exemption conditions in any of my previous reports on this matter. However, I discuss the issue in some detail in my response to the Commission's consultation on conditions for the LCS/WLR exemption (the same conditions as proposed for this exemption).²³ In that report I argue that such conditions are not only unnecessary and inappropriate, but they are also likely to be damaging for end-users.

I hold the same view with respect to the conditions proposed for the PSTN OA exemption. Moreover, I consider the case of the two CBD ESAs that would not be exempted from PSTN OA regulation were the Commission's proposed conditions to be imposed to be a striking example of the likely perverse impacts of these conditions.

I consider the conditions to be unnecessary in light of the competition assessment made by the Commission. As noted in section 4 above, the Commission appears to have chosen an exemption threshold which focuses on areas where there has already been sufficient competitor entry for effective competition. As is noted in the Draft Decision, the presence of four ULLS-based competitors 'will form the basis for effective competition in the downstream markets leading to lower prices and better quality and differentiated service offerings'.

Since sufficient entry for effective competition has already occurred in those ESAs within the Commission's exemption area, it is in my view clearly unnecessary to impose conditions aimed at ESAs for which the Commission believes there is limited scope for further entry (for example conditions on capped exchanges). It is not apparent to me what objective would be served by such conditions, aside from providing particular affected competitors with a regulated supply option at the expense of the costs that unnecessary regulation imposes.

In short, while potentially protecting some competitors, such conditions would not promote efficient competition.

As well as being unnecessary from a competition perspective, in my view these conditions are likely to be damaging to end-users. In ESAs where there has already been sufficient entry for effective competition (those ESAs in Commission's exemption area), the continued regulation of a resale-based supply alternative is only likely to hinder the efficient use of infrastructure and ultimately dampen facilities-based competition.

The Commission has noted in its Draft Decision the negative impact of resale regulation on incentives to compete using alternative infrastructure. This implies that resale regulation should be lifted wherever it is no longer required, specifically where there has been sufficient ULLS-based entry to form the basis for effective self-sustaining competition. Not doing so would mean imposing the costs of resale regulation, including weaker infrastructure-based competition, in areas where it is no longer necessary.

²³ Telstra, 'Expert report by Dr Paul Paterson of Concept Economics for Mallesons Stephen Jaques on the ACCC consultation on proposed conditions 'Telstra's local carriage service and wholesale line rental exemption applications'', August 2008

The Commission's conditions in its Draft Decision as they relate to CBD ESAs provide a prime example of the potentially perverse impact of these conditions. The Commission notes that while all 17 CBD ESAs meet the proposed exemption threshold of four ULLS-based competitors, exemption would not apply to two of these through the operation of the proposed condition relating to exchange capping (Pitt in Sydney and Roma St in Brisbane). This is despite the fact that these ESAs exhibit some of the strongest competitive characteristics of any in the country, including high levels of DSLAM-based entry and a plethora of alternative infrastructure (including fibre loops and fixed and mobile wireless coverage). For example, the Pitt exchange had [c-i-c] DSLAM-based competitors to Telstra in August 2007 and the wider Sydney CBD area had [c-i-c] fibre-based operators (see Table 1 in section 6 below).

Imposing conditions which have the effect of depriving such highly competitive ESAs of the benefits of exemption would be to ignore *competition* and focus solely on the interests of specific *competitors*. In my opinion the focus of the Commission's decision (and indeed competition policy more generally) should be on strengthening the competitive process not on protecting certain competitors.²⁴

Thus it is my view that the conditions proposed by the Commission should not be imposed. Given that the Commission has designed an exemption threshold which captures only ESAs where sufficient entry has occurred for effective competition, there should be no need for additional conditions on exemption. Indeed in a number of ESAs subject to the conditions (of which the Pitt ESA is an example), competition appears to be particularly intense. Imposing conditions where they are not necessary is only likely to dampen facilities-based competition where it is clearly viable and harm the interests of end-users. Therefore it is my view that these conditions should not be imposed at all.

²⁴ This view has also been expressed by economists and Australian courts. For example the High Court in *Boral* notes that one of the overarching objectives the *Trade Practices Act 1974* (Cth) is the promotion of the competitive process, not the protection of competitors whose interests may naturally be harmed by this process. See: *Boral Besser Masonry Limited v Australian Competition and Consumer Commission* 215 CLR 374 per Gaudron, Gummow and Hayne JJ.

6. SPECIFIC ISSUES RELATING TO CBD AREAS

In this section, I consider the impact of exemption specifically as it relates to CBD areas. In my view these areas warrant specific attention due to the very different competitive environment there. As noted in my previous reports on this matter, CBD areas are characterised not only by intense DSLAM-based competition, but also by strong rivalry based on alternative networks.²⁵ Despite this intense competition, exemption would not apply to 2 of the 17 CBD ESAs under the Commission's proposed conditions. For reasons I discuss in this section, I do consider such an outcome to be in the interests of end-users but rather, believe their interests would be furthered by not applying the exemption conditions in CBD areas (if they are to apply at all).

6.1. COMPETITION IN CBD AREAS

As noted in previous reports on this matter, the evidence before me strongly indicates that the competitive dynamic in CBD ESAs is altogether different from that elsewhere.²⁶ These ESAs have seen not only large-scale DSLAM-based entry and supply, but also the widespread deployment of alternative infrastructure. In most CBDs there are at least [c-i-c] DSLAM-based competitors as well as [c-i-c] fibre loop operators (Table 1) – the two ESAs subject to the Commission's proposed conditions are no exception.²⁷ Fibre, like DSLAM infrastructure, can be used to provide both voice (STS) and advanced data services to customers in CBD areas.²⁸ Fibre loop operators are clearly active in CBD areas, for example in Sydney fibre-based (non-Telstra) entrants have connected to more than [c-i-c] buildings.²⁹

The presence of both fibre-based and DSLAM-based operators across all CBD ESAs is important for two reasons. First, it provides evidence of a strong competitive constraint on Telstra's behaviour in these areas both at the retail and wholesale levels. Second, it demonstrates that in CBD areas, barriers to market entry are low not only for DSLAM-based operators, but also for operators of alternative infrastructure. In this respect CBD areas are clearly distinguishable from metropolitan areas where barriers to DSLAM-based entry have been shown to be low, but material barriers to competition based on alternative fixed infrastructure may still exist.

Table 1: [c-i-c]

²⁵ This important distinction between CBD and metropolitan areas was also noted by the Commission in its 2002 decision to exempt LCS in CBD areas (discussed later in this section). The Commission noted, after reviewing the evidence, that: 'it is apparent that investment in infrastructure has been concentrated in the CBD areas relative to metropolitan areas'. See: ACCC, 'Future scope of the local carriage service: final decision', July 2002, at p44

²⁶ Telstra, "Statement by Dr Paul Paterson of CRA International for Mallesons Stephen Jaques on the Economic Considerations for a PSTN Originating Access Exemption", Annexure A to "Telstra's PSTN Originating Access Exemption Application – Supporting Submission", October 2007.

²⁷ I also note the substantial presence of fixed wireless operators in CBD areas. However for the purposes of this discussion I focus primarily on fibre loop operators given the long-standing recognition of their role in imposing an alternative network constraint on Telstra (for example the Commission recognised this constraint in its decision to grant LCS exemption in CBDs: ACCC, 'Future scope of the local carriage service: final decision', July 2002).

²⁸ For example Pivit advertises that it is able to provide telephony services compliant with ACMA's STS requirements over its fibre infrastructure. See: <http://www.pivit.com.au/index.php/pivit-solutions/fi-tel-telephony-services>

²⁹ [c-i-c]

Whilst the mere presence of alternative network operators in CBDs is in my view sufficient evidence of low barriers to this form of competition, I also consider other indicators of the presence or otherwise of such barriers. In particular, I consider evidence presented to me on the costs of such entry.³⁰ The key evidence of such costs is contained in a report prepared by Craig Lordan of Evans & Peck, which estimates the cost of connecting fibre to CBD buildings in each of the capital city ESAs.³¹ This report indicates that such costs are very low, particularly if conduits are leased rather than installed. Payback analysis based on these estimates conducted by Michael Smart of CRA International indicates that an operator making such investments would recoup in a very short period of time. In Sydney and Brisbane (where the Pitt and Roma St exchanges are located), the payback period is estimated to be [c-i-c] if conduits are leased.³²

Perhaps more significantly, Mr Lordan's estimates indicate that for the two CBD ESAs which would not be exempted under the Commission's proposed conditions, these costs are no higher than for other ESAs in the same city.³³ This implies that based on the costs of fibre-based entry, barriers to this form of competition are no higher in the two CBD ESAs potentially deprived of exemption.

The evidence presented above points not only to a significant presence of facilities-based competitors, but also to the potential for further facilities-based entry in *all* CBD ESAs. Both these factors are likely to impose a significant constraint on Telstra's behaviour in the absence of exemption. This competitive constraint in CBD areas has been observed by the Commission, most notably in its 2002 decision to exempt the local carriage service:³⁴

The presence of such alternative infrastructure and services is believed to be sufficient to serve as substitutes to the Local Carriage Service and act as a constraint on the Local Carriage Service price that Telstra would be able to charge... Moreover the Commission is of the view that the availability of the Local Carriage Service is preventing these alternative infrastructure and services from being used more extensively to originate calls than is the case at present.

I agree with this reasoning and suggest that there is no reason why it cannot be applied to the current inquiry. The substitutability of alternative infrastructure with respect to local call origination should apply equally to the origination of all calls, and therefore the constraints on LCS pricing in CBD areas referred to by the Commission should apply equally to PSTN OA. The competitive constraints imposed by alternative infrastructure in CBDs relate to the full bundle of fixed voice services and therefore it makes no sense to maintain resale regulation of one component of this bundle in two CBD ESAs.

³⁰ Notably, costs of entry will not always constitute barriers to entry in an economic sense, particularly if such costs are recoverable upon exiting the market (ie if such costs are not sunk costs). Nevertheless, for the purposes of this analysis I assume all costs of fibre-based entry to be sunk, thus producing a conservative view of entry barriers.

³¹ Evans & Peck, 'Estimated optic fibre cable installation costs within CBD Areas', report prepared for Mallesons Stephen Jaques, 20 December 2007

³² [c-i-c]

³³ [c-i-c]

³⁴ ACCC, 'Future scope of the local carriage service: final decision', July 2002, at p52

6.2. IMPLICATIONS FOR THE PROPOSED EXEMPTION

Given the significant presence of both DSLAM-based and alternative network operators in CBDs, it is my view that there will be a significant competitive constraint on Telstra's pricing of PSTN OA and downstream products in CBDs in the absence of exemption. In addition to the constraints imposed by competitors already present, there is likely to be significant constraint from potential entrants given the low barriers to market entry (either DSLAM-based or full facilities-based entry). For these reasons, if the Commission decides to condition exemption, CBD areas should be distinguished from metropolitan areas and not be subject to the Commission's proposed conditions.

Despite the restriction on further ULLS-based entry from 'capping' in two of these ESAs, in my view efficient competition and infrastructure use will be promoted by exemption in all CBD ESAs. In all of these ESAs there is already a strong competitor presence as well as the potential for further competitive entry (whether that entry be from ULLS-based or full facilities-based operators) – the Pitt and Roma St ESAs are no exception in this respect. Moreover exemption is likely to promote such competitive entry and facilitate more efficient use of existing infrastructure in CBD areas. Therefore it is my view that if conditions are imposed at all (and for reasons discussed in section 5, I believe they should not be), they should not apply in CBD ESAs in line with the distinct competitive dynamic there. This would allow the benefits of exemption to flow to all 17 CBD ESAs where facilities-based competition is evidently viable.

As noted in section 5, I consider the proposed conditions have the effect of placing undue weight on the interests of specific competitors unable to deploy DSLAMs in certain exchanges. Whilst I consider this to be the wrong focus (efficient competition should be the focus), I briefly consider the prospects for these competitors in CBD areas.

In my view there is no reason why these competitors would not be able to continue supply based on wholesale inputs. As noted in my previous reports and by the Commission in its Draft Decision, it is likely that given DSLAM-based competition in the exemption area, access seekers would continue to be able to acquire such inputs in the event of exemption, to the extent that this is efficient. Since market forces would ensure such supply in the exemption area, there is no need for ongoing regulation as imposed by the proposed conditions.

Moreover, in CBD areas competitors unable to deploy DSLAM infrastructure will have yet another set of supply options resulting from the presence of alternative infrastructure. These additional supply options in CBD areas may include:

- Greater use of existing fibre infrastructure owned by the access seeker;
- Access to existing fibre infrastructure owned by other carriers; or
- Deployment of new fibre infrastructure.

Given the extent of fibre deployment in CBD areas and the evidence relating to the costs of such deployment presented above, it would appear that there are no material barriers to any of these forms of supply. Moreover this form of competitive supply is likely to promote the interests of end-users through more efficient use of infrastructure and greater facilities-based competition.

7. CONCLUSIONS

Whilst I continue to hold the view that exemption as proposed by Telstra is likely to be most beneficial to end-users, I consider the exemption proposed by the Commission to be a step in the right direction. Although overly conservative in scope, it is likely to promote efficient competition and infrastructure investment where it applies. By lifting resale regulation in certain areas, the PSTN OA exemption is likely to promote the use of existing DSLAM infrastructure (and indeed fibre infrastructure in CBD areas), facilitate deployment of new infrastructure and consequently enhance facilities-based competition. As noted by the Commission, this form of competition is likely to be most beneficial to end users by allowing product differentiation, innovation and competition on both price and non-price terms.

Nonetheless in my view the Commission's proposed exemption unnecessarily limits these benefits of exemption to areas where sufficient entry for effective competition has already occurred. As I have opined in previous reports, exemption should extend not only to areas where a satisfactory level of ULLS-based entry has already occurred, but also to areas where barriers to such entry are low. These barriers have been demonstrated to be low in ESAs where at least one DSLAM-based operator has entered, and hence in my view the threshold for exemption should be the presence of one competitor DSLAM. A higher threshold (such as that proposed by the Commission) risks imposing the costs of resale regulation on ESAs where the potential for ULLS-based competition makes it unnecessary.

The imposition of conditions similarly risks unnecessarily limiting the benefits of exemption to certain areas. In my view the proposed conditions serve no purpose other than to provide affected access seekers with a regulated supply option. Since sufficient entry has occurred for effective competition across the Commission's exemption area, there should be no need for conditions on exemption.

This is particularly the case for CBD areas where there has been widespread entry not only by DSLAM-based operators, but also by fibre operators. The presence of alternative infrastructure in these ESAs not only strengthens the competitive constraint on Telstra, but it also broadens the range of supply options open to entrants. For these reasons, should the Commission choose to impose conditions, it is my view that these should not apply to CBD ESAs.



APPENDIX A INSTRUCTIONS FROM MSJ

[c-i-c]



APPENDIX B CURRICULUM VITAE

	Bachelor of Agricultural Economics
DR PAUL PATERSON	(First Class Honours)
Executive Director	University of New England
	Master of Economics
	Australian National University
	Ph D (Economics)
	Australian National University

Paul Paterson is an Executive Director and Head of Telecommunications Consulting at Concept Economics, an Australian-based consulting firm with particular expertise in competition economics. Paul has been with Concept Economics and its predecessor CRA International since 2004, bringing commercial and government experience in industry analysis, corporate strategies, regulation and policy development. Paul has senior executive experience in the telecommunications industry. Prior to joining NECG, he was with Telstra Corporation Ltd as Director Regulatory from 2001 to 2004.

Prior to his appointment as Director Regulatory at Telstra, Paul was the Group Manager Competition, Regulatory and External Affairs for Telstra from 1998 to 2001. Until leaving Telstra he was on the Board of the Australian Communications Industry Forum. Paul has authored numerous economic reports and publications since 1978.

As a founding member of the Regulated Industries Forum in 2003, and convener since then, Paul also has extensive insight into regulatory issues in the utilities and transport sectors.

Experience

Paul has provided advice on regulatory, competition, commercial, strategic and government policy matters to major corporations and government agencies in telecommunications and other network industries. Jurisdictional experience spans Australia, New Zealand, Singapore, Hong Kong, Japan, United Kingdom, Ireland, Italy and the USA.

Professional History

March 2008 – present	Executive Director, Operations and Head of Telecommunications Consulting, Concept economics
2004 – 2008	Vice President, CRAI, Australia
2004	Principal, NECG, Australia

2001 – 2004	Director Regulatory, Telstra
1998 – 2001	Group Manager Competition, Regulatory and External Affairs, Telstra
1992 – 1998	Executive Director, Policy & Resources, Department of State and Regional Development (previously Chief Business Economist, Office of Economic Development, New South Wales Premier's Department), Sydney
1988 – 1992	Chief Economist, OTC Limited (now Telstra), Sydney
1987	Visiting Economist, Department of the Treasury, Canberra
1986	Special Advisor, Department of Trade, Canberra
1985 – 1986	Assistant Director, Bureau of Labour Market Research, Canberra
1983 – 1984	Administrator, Organisation for Economic Co-Operation and Development, Paris
1980 – 1983	Senior Project Manager, Bureau of Labour Market Research
1977 – 1980	Project Manager, Bureau of Agricultural Economics

Selected Publications, Presentations and Reports

H Ergas & P Paterson (1990) **The Joint Provision of International Telecommunications services: An Economic Analysis of Alternative Settlement Arrangements** 8th International Telecommunications Society Conference, Venice, March 1990.

D Shiff & P Paterson (1990) Regulatory Issues for International Telecommunications in the **New Environment: How do Overseas Arrangements Inform the Australian Situation?** Paper presented to the International Telecommunications Law and Policy Conference, Sydney, December 1990.

OTC Ltd **OTC's Operating Environments to the Year 2000: A Scenario Analysis** (research leader and joint author of this confidential OTC report).

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