TELSTRA CORPORATION LIMITED

Submission to the Australian Competition
and Consumer Commission

DTCS Exemption Application of 24 August 2007
(Capital-Regional Transmission)

Telstra's Response to Commission Draft Decision

October 2008

Overview

Telstra welcomes the Commission's proposed decision of 22 September 2008 ("**Draft Decision**") to exempt the supply of the domestic transmission capacity service ("**DTCS**") on 9 capital-regional routes from the standard access obligations. However Telstra considers that the Commission should also grant exemption in respect of a further 9 routes and that the exemption should be granted with immediate effect of the final decision being made (i.e., no transition period is required).

Three aspects of the Draft Decision are of particular concern:

(a) The Commission's criteria for exempting specified capital-regional routes should be based on a rule (such as the "5% rule" proposed by Telstra) that takes account of the distance of the regional centre from the capital city. Even if other considerations (such as volume/quantity) are also relevant, the distance of the regional centre from the capital city remains a major determinant of the competitive price for a capital-regional route. The Commission's "1 km rule" takes no account of distance. Additionally, the Commission has not provided any real basis for the 1 km rule, either in the Draft Decision, or in its 2004 decision. It is ironic that the Commission proposes to reject the 5% rule because the Commission does not think it satisfies the LTIE (which Telstra disagrees with) and yet the Commission does not demonstrate how the 1 km rule satisfies this threshold.

(b) Even if the Commission adopts its 1 km rule, the exemption should include the Brisbane-Cairns and Brisbane-Mackay routes. There are at least three competitors with fibre that is within 1 km of the GPOs of Cairns and Mackay.

(c) There is no need for a transition period. There are three reasons for this. First the relevant routes are already clearly competitive, and are likely to have been competitive for some time. Second, there is a high level of industry acceptance of transmission pricing in light of the lack of disputes over the past 12 years (during which the Commission has not been required to determine pricing in an access arbitration). Consequently there would be no adverse impacts in the market by having the exemption take immediate effect. Third, as the Commission itself acknowledges, the mere threat of entry is sufficient to have an immediate constraint on the incumbent (even though the

Commission's application of the test looks solely at existing competitors). Given these three factors, there is no justification for a transition period before the exemption should take effect. In addition, the Commission did not consider a phase-in period was required for the exclusion of inter-capital routes from declaration in both 1998[1] and 2001[2], and the exclusion of certain capital-regional routes from declaration in 2004[3].

The Draft Decision contains a number of criticisms of Mr Mike Smart's Critical Loss Analysis which Telstra considers to be incorrect and unjustified. Telstra has invited Mr Smart to respond to those criticisms. His response explaining how the Commission errs in its criticism of his Critical Loss Analysis is in **Annexure 1**.

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1 ACCC, Competition in data markets - A final report on whether to declare certain ISDN services, and whether to amend declarations for the digital data access service and transmission capacity under Part XIC of the Trade Practices Act 1974, November 1998.

2 ACCC, Domestic Transmission Capacity Service - A final report examining possible variation of the service declaration for the domestic transmission capacity service, May 2001.

3 ACCC, Transmission Capacity Service: Review of the declaration for the domestic transmission capacity service, Final Report, April 2004.

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1 Geographic boundaries of a regional centre - length of the capital-regional route is a relevant consideration

Telstra's position in a nutshell:
▪ The geographic boundaries of a regional centre should be based on the "5% rule" which is a well accepted economic approach. ▪ If the Commission is concerned that the 5% rule results in very large geographic boundaries, the geographic boundaries of a regional centre could be based on a "modified 5% rule". ▪ The Commission has not advanced any reason why the 1 km rule promotes the LTIE. The 5% rule proposed by Telstra should be adopted as it promotes the LTIE.

1.1 Why is the length of the capital-regional route relevant to the boundaries of a regional centre?

The Draft Decision exempts only capital-regional routes that meet the "1 km rule". Under this rule, a capital-regional route is exempted only where "*there exists two infrastructure owners, other than Telstra, that have an existing optical fibre network that passes within a 1 km radius from a regional town's GPO, on a given capital-regional route*".[4] Under the 1 km rule, the geographic boundaries of a regional centre are "*1 km or less from the GPO of a regional centre for a given capital-regional route*".[5]

The 1 km rule limits the geographic boundaries of a regional centre to 1 km of the GPO for all capital-regional routes, regardless of how far the regional centre is from the capital city. The 1 km limit is completely arbitrary; it is also inconsistent with the general competition law approach to market definition.

In general competition law, the market includes all firms that would prevent the incumbent(s) from sustainably charging a price above the competitive

4 This formulation of the 1 km rule is based on various passages in the Draft Decision on market definition, concentration levels and barriers to entry, including the passage quoted above at p 46 of the Draft Decision.

5 Draft Decision, p 36.

price.[6] Under this approach, the boundaries of a regional centre should encompass all firms that could profitably meet demand for capital-regional transmission (including by building a spur to the regional centre) if Telstra imposes a SSNIP[7] over the competitive price.

A potential competitor is in the same market if it would find it profitable to defeat the SSNIP by building a spur. Doing so is profitable if (assuming a SSNIP of 5%):

> The cost of building a spur
>
> < Competitive Price x (1+5%) x (Volume served by the entrant[8])

The competitive price is based on the average cost to the incumbent of provisioning the capital-regional transmission.[9] The average cost is in turn based on the length of the route. All other things being equal, the longer the route, the higher the average cost, and therefore the higher the competitive price. The higher the competitive price, the longer the maximum length a spur can be and still remain profitable to build.

The above reasoning implies the following conclusion:

> The longer the capital-regional route, the wider the market boundaries of a regional centre are.

6 See for example the Commission's Merger Guidelines (June 1999), paragraph 5.44, p. 33 on determining the boundaries of a geographic market.

7 Small but Significant Non-transitory Increase in Price.

8 M Smart's supplementary report of 20 October 2008 (see p 3) considers to what extent a new entrant meeting the 5% rule could profitably build a spur if only a percentage of the incumbent's existing sales are contestable. M Smart finds that for very short capital-regional routes (i.e., less than 20 km), entry is profitable if the entrant captures at least 9.1% of the incumbent's sales. For much longer routes, the percentage of incumbent sales that must be contestable falls. For example, for 500 km, entry is profitable if the entrant captures just 4.9% of the incumbent's sales. Whatever the minimum percentage of the incumbent's sales that are contestable is, the longer the capital-regional route, the longer the maximum spur distance for profitable entry can be.

9 As M Smart notes in his report of 23 August 2007 (at paragraph 13), the base price level against which a SSNIP is measured should be the competitive price. Failure to observe this requirement would be to fall into the "cellophane fallacy". The competitive price of a transmission service along a capital-regional route is taken to be the average cost of provisioning transmission capacity along that route. This is simply the total cost (including capital expenditure) of building transmission capacity along that route divided by the volume/quantity currently being supplied. In footnote 4, M Smart also notes that equating the competitive price with average cost assumes the absence of network effects. This is appropriate given the Commission market definition that treats each point-to-point route as a separate market.

The Commission should use a broader geographic boundary than 1 km for longer routes.

1.2 Are other considerations (e.g., volume) relevant?

The Commission considers that volume/quantity is also relevant to an entrant's consideration as to whether building a spur would be profitable if the competitive price were to increase by a SSNIP.[10]

Telstra responds as follows:

(a) First, the length of the capital-regional route remains a relevant consideration even if other considerations are also relevant. Accordingly, a principled approach to defining the geographic boundary of a regional centre should take account of the length of the capital-regional route (as well as any other relevant consideration). Telstra's 5% rule is an example of a rule that takes account of length. The Commission's "1 km rule" does not.

(b) Second, volume/quantity **is** taken into account in the 5% rule. The competitive price for a capital-regional route (which the SSNIP applies to) can be assumed to take account of volume/quantity, for the following reasons:

- The competitive price is equal to average cost, which in turn is the total cost of provisioning transmission capacity (including capital expenditure) over the capital-regional route divided by quantity of transmission capacity currently being supplied by the incumbent over that route. Importantly, average cost is calculated by dividing total cost over existing volume/quantity; it is not calculated by dividing total cost over the maximum volume/quantity that could be supplied.

- The lower the volume/quantity over a capital-regional route, the higher average cost is, and therefore the higher the competitive price will be.

10 For example, at p 37 of the Draft Decision, the Commission says that *"the theoretical model, on which Mr Smart's arguments are based, is mis-specified. This is based on the position that for a*

- Under average-cost pricing, revenue for the route will be matched to infrastructure costs whether the traffic volume is high or low.

- The critical loss is the smallest percentage loss of sales, $\triangle q/q$ that would make the price increase unprofitable. Volume lost from the incumbent to a competitor is integral to the analysis.

Mr Mike Smart's supplementary report of 20 October 2008 addresses the question of volume/quantity in greater detail.

(c) Third, the critical issue is not how large a volume or quantity is available to a new entrant per se, but how much volume/quantity a competitor could win from the incumbent to make a SSNIP unprofitable to the incumbent. A firm that meets the 5% rule would make a SSNIP unprofitable for the following reasons:

(i) In the context of long-distance transmission over fibre, once an entry decision is taken, a competitor's fibre capacity is likely to be much larger than the volume/demand at a given route.

(ii) Furthermore, it turns out that the Critical Loss is between 4.8% and 9.1%[11] of the incumbent's current volume/quantity. This means that an attempt to raise price from its competitive level by 5% would be unprofitable to Telstra if it would result in Telstra losing 9.1% of its existing sales assuming the route is short (and 4.8% assuming the route is long).

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correct evaluation of average or marginal cost, inclusion of volumes/quantities is required. However this position is not reflected in Mr Smart's analysis."

11 The derivation of the Critical Loss is set out in M Smart's report of 23 August 2007 (see paragraphs 9 to 11). Assuming a SSNIP of 5%, the Critical Loss = 5%/(5% + Lerner Index). The Lerner Index ("L") is a measure of market power; it is equal to price ("P") minus marginal cost ("MC") divided by price. L = (P-MC)/P. Assuming short run marginal cost is close to zero (which characterizes capital-regional transmission), the Lerner Index = 100%. Therefore, Critical Loss (in percentage terms) = 5%/(5% + 100%) = 4.48%. 4.48% is the smallest percentage loss of sales ("$\Delta Q/Q$") that would make a 5% increase in price unprofitable if marginal cost is zero. M Smart later adjusts the Critical Loss calculation to take account of long-term marginal cost. For very short routes where equipment costs dominate, the Lerner Index could potentially be as low as 50% and the Critical Loss (in percentage terms) = 5%/(5% + 50%) = 9.1%. (See M Smart's 27 March 2008 report, paragraphs 24-25 for the explanation.)

(iii) So long as the new entrant's capacity exceeds 9.1% of the existing volume/quantity sold by Telstra (which is manifestly the case), a rival with fibre infrastructure within a distance of less than 5% of the route distance from the GPO could defeat any attempt by Telstra to impose a SSNIP.

(iv) The credible threat of Telstra losing more than 9.1% of its current volume/quantity to a new entrant would be sufficient to constrain Telstra from raising its competitive price (assumed to be at competitive levels) by 5%. This threat would be credible for any entrant to whom the cost of building a spur is less than the expected revenues the entrant would receive if at least 9.1%[12] of Telstra's customers were to switch to the new entrant in response to a 5% increase in Telstra's price.

In addition to rejecting Telstra's 5% rule (which as mentioned above ought to be adopted by the Commission in granting the exemption application), Telstra notes that the Commission provides no analysis of Optus' suggestion of 4-5km from the GPO, and why that distance from the GPO would not promote the LTIE. In Telstra's view, if the Commission proceeds to reject Telstra's 5% rule, the Optus 4-5 km distance provides a more reasonable outcome that the Commission's 1km rule.

Conclusion: The Commission's approach to geographic market definition ought to take account of the length of the capital-regional route, whether or not volume/quantity is also a relevant consideration. The Commission's 1 km rule fails to do so. Indeed the Commission's approach does not take account of volume/quantity at all. As Telstra's rule takes these and other factors into account, the Commission ought to adopt Telstra's 5% rule as the basis for determining the routes which meet the LTIE criteria.

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12 The derivation of 9.1% is set out in M Smart's report of 20 October 2008 (see p 3) and applies for capital-regional routes of 20 km. For longer routes, the percentage decreases to 5.7% (for 100 km routes) and 4.9% (for 50 km routes). Note that 9.1% (in the case of 20 km routes) represents the minimum percentage of the incumbent's sales that a rival would have to gain ("entrant critical market share") for a rival meeting the 5% rule to profitably build a spur to the GPO. This should not be confused with the "critical loss" which is the minimum percentage of the incumbent's sales which, if lost, would make a 5% SSNIP unprofitable. The critical loss is separately derived in M Smart's report of 27 March 2008 (see p 5). For very short routes, the critical loss is also 9.1%. As with the "entrant critical market share" percentage, the "critical loss" percentage decreases for longer routes.

1.3 Sunk costs are addressed in the 5% rule

The Draft Decision refers to sunk costs as a reason for preferring the 1 km rule. On the one hand, the Commission notes Optus' submission that the construction of a spur line would involve significant, irreversible new investment.[13] On the other hand, the Commission takes the view "*where existing optical fibre meets the 1 km criteria for a regional town, the market is contestable because an infrastructure owner could build a link … without incurring excessive sunk costs.*"[14]

The Commission appears to accept that sunk costs are acceptable provided that the overall cost is limited to fixed costs incurred for 1 km spur installation. This approach takes no account of the fact that investment decision making is based on an assessment of the costs relative to expected revenue, and it is the relative comparison of cost to revenue that ought to determine whether costs are excessive.

In contrast, the 5% rule does compare the relative costs with the likely revenue benefit. It is derived by comparing the cost of building a spur with the likely incremental revenue if the incumbent were to charge a price that is above the competitive price by a SSNIP of 5%. Specifically, the 5% rule determines what the maximum length of the spur may be, subject to the constraint that it must be profitable for a prospective entrant to build the spur. Mr Mike Smart's supplementary report of October 2008 identifies the conditions in which a prospective entrant can expect to displace the incumbent's service, and explains why those conditions are valid for capital-regional transmission markets.[15]

The Commission may be concerned that the prospect of a possible price reaction by the incumbent to new entry could deter a prospective entrant from building a spur - even if the incumbent raises its price (above the competitive price) by a SSNIP of 5%.[16] Telstra's response to this concern is as follows:

(a) First, concern over excess capacity (as the Commission notes at p 57 of

13 Draft Decision, p 40.
14 Draft Decision, p 59.
15 M Smart (October 2008), p 5.
16 Draft Decision, p 38.

the Draft Decision) has not deterred new investments in capital-regional transmission markets. A prospective entrant can sign up customers prior to building its network.[17] Any risk of asset stranding post-entry can be managed through long-term contracts with customers prior to committing to sunk investments.[18]

(b) Second, the issue is whether the presence of a firm with infrastructure that just meets the 5% rule is a competitor at the relevant capital-regional route. The test for determining whether that firm is a competitor is simply whether the presence of that firm prevents the incumbent from implementing a small but **non-transitory** increase in price. If the firm's presence constrains the incumbent in this manner, that firm is a competitor - *see* Box 1.

Box 1: Why is a firm that just meets the 5% rule a competitor?

To see why a firm just meeting the 5% rule is a competitor, consider two scenarios:

(A) The incumbent faces a rival that has infrastructure just outside the 5% rule distance.

(B) The incumbent faces a rival that has infrastructure just within the 5% rule distance.

It is possible for the incumbent to implement a non-transitory increase in price (of 5% above the competitive level) in Scenario A, but not in Scenario B. In Scenario A, the rival could not profitably supply to the regional centre at the increased price even if the price is maintained at 5% above the competitive level on a non-transitory basis. In Scenario B, the rival could profitably supply to the regional centre at the increased price provided that price is maintained at 5% above the competitive level on a non-transitory basis.

In Scenario B, the incumbent is only precluded from raising the price to 5% above the competitive level on a non-transitory basis. The incumbent is not precluded from raising the price to 5% above the competitive level on a temporary basis. Therefore significant but transitory increases in price is possible under Scenario B.

As Box 1 illustrates, the presence of a rival that is just within the distance from a regional centre under the 5% rule does not necessarily preclude a transitory increase in price to 5% (or even higher) above the competitive price. However, that is not the test for whether the rival is

17 Draft Decision, p 58.
18 M Smart (October 2008), p 6.

a competitor at the capital-regional route. The test is whether a non-transitory increase in price is possible.

(c) A finding that a non-transitory increase in price to 5% above the competitive price is not possible is a **necessary and sufficient condition** for determining whether the rival is a competitor at a capital-regional route. Any further requirement that entry should not be deterred by the prospect of a price response by the incumbent would, in effect, be an alteration of the SSNIP test. The test for defining the geographic scope of the market would no longer be based on whether the rival prevents the incumbent from charging a **non-transitory increase** in price of 5%. The test would instead be whether the rival prevents the incumbent from charging a **transitory increase** in price of 5%.

(d) Even if it is appropriate for the Commission to be concerned about whether entry could be deterred by the prospect of a price response - and Telstra strongly submits that this would be inappropriate - this is not a material concern for the following reasons:

(i) First, as noted earlier, any risk of asset stranding post-entry can be managed through long-term contracts with customers prior to committing to sunk investments.

(ii) Second, the incumbent is unlikely to engage in a vigorous price response post entry in circumstances where this would lead to expectations of reduced pricing in other capital-regional routes.

1.4 Entry into the market is based on the entrant's impact on the incumbent's pricing regardless of build

The Draft Decision seems to stress the importance of entry into the market. At p 38:

> "The ACCC also notes Mr Smart's comments that, in applying the 5% rule, it cannot be inferred that a firm with a fibre network within 5% of a regional centre would actually enter the market."

The ACCC seems to have confused "entry into the market" with "building a spur". There is a prior question as to whether "building a spur" is a market entry decision or simply an operational decision post market entry. The answer to this prior question is based on the SSNIP approach to market definition. Under the SSNIP approach, the geographic market begins with the incumbent (or set of incumbents) and is expanded to include the next closest rival such that all rivals within the market can profitably institute a SSNIP. If the incumbent faces a rival that is just within the 5% rule, the geographic market includes the rival if and only if the incumbent cannot profitably institute a SSNIP without the rival co-operating. This reasoning is set out in the following way at paragraph 3.23 of the ACCC's draft Merger Guidelines of 2008:

> "The process of applying the [Hypothetical Monopolist Test] starts with one of the product and geographic areas of supply covered by one or more of the merger parties. These are then extended in product and geographic space to include the next closest demand substitute. If the hypothetical monopolist of this extended group of products cannot profitably institute a SSNIP because of customers switching to alternative products, the next best substitute is added. The collection of products is expanded until a hypothetical monopoly supplier of all those products could profitably institute a SSNIP."

If a SSNIP cannot be instituted because of the presence of a rival that is just within the 5% rule, that rival is already "in the market". The test for determining whether the rival is part of the market is whether the rival constrains the incumbent's pricing behaviour, not whether the rival would actually build a spur to the regional centre. Where a firm meets the 5% rule, it is incorrect to think of a decision by the firm to build a spur as an "entry" since the firm is already in the market. Rather, any decision to build a spur is simply an operational decision for a firm that is already in the market, not a market entry decision. Whether the firm actually builds a spur to the GPO (or to somewhere else in the regional centre) is not relevant to whether the firm is part of the market.

1.5 "Modified 5% rule"

To the extent the Commission considers that the 5% rule is inappropriate for very long capital-regional routes (e.g., Brisbane to Cairns), the 5% rule could be modified to include a distance cap of 6 km - e.g.:

> The geographic boundary is a regional centre is a distance from the GPO equal to 5% of the length of the capital-regional route, subject to a maximum distance of 6 km.

While not ideal, such a rule continues to take account of the length of the capital-regional route. The distance cap must be sufficiently large so that the 5% rule has meaningful application (which is clearly not the case with a 1 km cap).

A 6 km distance cap is not unreasonable given that Optus proposes a threshold distance of 4 to 5 km for measuring the geographic boundaries of a regional centre.[19]

2 Competitor count - has the Commission omitted capital-regional routes that meet the 1 km rule?

Telstra's position in a nutshell:
▪ The Brisbane-Cairns and Brisbane-Mackay routes meet the 1 km rule and should be included in the Commission's exemption order.

2.1 Excluded routes - the Commission should provide reasons for the exclusion

The Commission has excluded the following five routes from exemption even though Market Clarity's letter of 11 March 2008 states that there are at least 3 fibre owners within 1 km of the regional centre:

(a) Brisbane to:

(i) Cairns;

19 Optus, Optus Submission to the Australian Competition and Consumer Commission on Telstra's Exemption Application for the Domestic Transmission Capacity Service, November 2007 (confidential version), paragraphs 1.7, 2.5 and 2.42.

(ii) Gladstone;

(iii) Mackay;

(b) Sydney to:

(i) Armidale;

(ii) Wagga Wagga.

The Commission has not provided any reasons for that exclusion. Telstra requests that it do so.

2.2 The Brisbane-Cairns and Brisbane-Mackay routes appear to meet the 1 km rule

[c-i-c: Commission only] [c-i-c: Commission only]

3 Drafting

The draft exemption order defines the DTCS Declaration as "*the Declaration made by the Commission under 152AL(3) …, as varied from time to time*". Consistent with exemption orders made by the Commission in other contexts, the exemption order for DTCS should allow for the prospect of a re-declaration of the DTCS as well as its variation. Without endorsing the scope of the exemption order proposed by the Commission (which Telstra considers is too narrow for the reasons outlined above), Annexure 2 sets out a draft exemption order with changes (marked up) that Telstra suggests the Commission adopt.

Telstra Corporation Limited

21 October 2008

Annexure 1 - Statement of Michael Smart of LECG dated 20 October 2008

Annexure 2 - Draft Order

Appendix E: DRAFT ORDER in respect of Telstra's DTCS exemption application of 24 August 2007

Order under paragraph 152AT(3)(a) by the Australian Competition and Consumer Commission in respect of Telstra's DTCS individual exemption application of 24 August 2007

Individual exemption from standard access obligations in respect of DTCS

1. Title

This Order may be cited as Individual Exemption Order No. X of 2008.

2. Commencement and Expiry

(1) This Order comes into effect 12 months after the date of release of the Commission's Final Decision on Telstra's individual applications for exemption from the standard access obligations set out in section 152AR of the Act in respect of DTCS in certain nominated areas, lodged 24 August 2007.

(2) This Order will expire on 31 December 2012 or the expiry or revocation of the DTCS Declaration, whichever occurs first.

3. Interpretation

(~~3~~1) Unless the contrary intention appears, where words or phrases used in this Order are defined in the *Trade Practices Act 1974,* the *Telecommunications Act 1997* or the instrument declaring the declared service, those words or phrases have the same meaning in this Order.

(~~4~~2) In this Order, unless the contrary intention appears –

Act means the Trade Practices Act 1974 (Cth).

Commission means the Australian Competition and Consumer Commission.

DTCS means domestic transmission capacity service declared by the Commission under subsection 152AL(3) of the Act pursuant to the DTCS Declaration.

DTCS Declaration means the Declaration made by the Commission under 152AL(3) of the Act in respect of the DTCS with effect from the 7 April 2004 and published in the Commonwealth of Australia Gazette No. GN 14 of 7 April 2004, as varied from time to time and any subsequent re-declaration of the DTCS.

Note: The Commission may extend or further extend the expiry date of the DTCS Declaration under subsection 152ALA(4).

Final Decision means the written statement setting out the Commission's final decision titled '*Telstra's domestic transmission capacity service exemption applications – final decision and class exemption*' dated XX 2008.

Telstra means Telstra Corporation Limited (ACN 051 775 556)

4. Exemption

Telstra is exempt from the standard access obligations set out in section 152AR of the Act in respect of the supply of DTCS between:

(1) a transmission point in Sydney and a transmission point in any of the following regional centres: Campbelltown, Gosford, Coffs Harbour and Goulburn;

(2) a transmission point in Brisbane and a transmission point in any of the following regional centres: Townsville, Rockhampton, Bundaberg and Maryborough;

(3) a transmission point in Adelaide and a transmission point in Port Augusta.

[Signed]

………………………..
Graeme Julian Samuel
Chairman

DATED: ..……………. 2008