



TELSTRA CORPORATION LIMITED

Submission to the Australian Competition
and Consumer Commission

Telstra Response to Questions from
ACCC Discussion Paper of October 2007

November 2007

Introduction

In this submission Telstra responds to issues raised by the Commission's Discussion Paper ("Discussion Paper") of October 2007 in relation to Telstra's application for exemption ("Exemption Application") from the standard access obligations applicable to Telstra in respect of the domestic transmission capacity service ("DTCS") dated 24 August 2007.

Terms used in this submission have the meanings defined by Telstra in its submission in support of the Exemption Application ("Telstra Submission"). In responding to these questions, Telstra relies on material it has already lodged in support of its Exemption Application. Specifically, Telstra relies on the following documents which have been provided to the Commission in support of the Exemption Application:

- (i) Report from Market Clarity ("**Market Clarity Report**");
- (ii) Statement of Mike Smart ("**Mike Smart Report**"); and
- (iii) Witness Statement at Annexure 3 of the Telstra Submission.

Telstra's Exemption Application seeks an exemption from the standard access obligations under Part XIC of the Trade Practices Act in relation to 20 nominated capital to regional routes. These were selected on the basis that ample competition exists for the supply of the DTCS over those routes as demonstrated by their having at least three suppliers of the service using their own optical fibre. Indeed, on half of these routes, there are more than three suppliers.

Further, as mentioned in the material supporting the Exemption Application, there are also likely to be many other routes which are also subject to effective competition, and which ought to be exempted from the standard access obligations, but which are beyond the scope of the current Exemption Application.

For example, Telstra's Exemption Application does not consider the question of whether the threshold of three DTCS suppliers is too high- and it may well be the case that routes on which there are two suppliers are sufficiently competitive to warrant exemption. Similarly, Telstra did not consider whether DTCS supplied using other technologies, such as microwave, also creates a sufficient competitive threat to suppliers of the service using optical fibre. In these respects, Telstra's Exemption Application is conservative, and likely

understates the level of competition currently experienced in relation to the supply of DTCS.

Where appropriate and to ensure succinctness, Telstra refers to responses it has made to other sections of the document in instances where the Commission has requested substantially similar information in multiple questions. In addition, the Commission's numbering of the questions in the Discussion Paper has been retained below for ease of reference.

Response to Commission Questions

5.1 Enduring Bottlenecks

Should DTCSs be considered as enduring bottlenecks?

A bottleneck occurs when a single entity owns the infrastructure that competitors want access to. Importantly, it is the provision by a unique supplier that makes the infrastructure a bottleneck. When another provider decides to supply competing infrastructure, there is no longer a bottleneck by definition. For the bottleneck to be enduring the situation of one supplier must have been the case for some period of time or be expected to persist into the future.

The DTCS cannot be considered an enduring bottleneck along capital-regional routes where there are at least 3 optical fibre operators (i.e. Telstra plus two competitors) because of the existence of workable competition (see Telstra Submission, pp.4-5).

It is also questionable whether DTCS is an “enduring bottleneck” on routes where there are less than 3 optical fibre operators. For example, the existence of just two optical fibre operators on a route (i.e. Telstra plus one competitor) indicates that optical fibre based transmission is economical to duplicate on that route (see Telstra Submission, pp.10-11). To that extent DTCS is not a bottleneck. In addition, it is also possible that DTCS supplied using alternative technologies, such as microwave should be included when determining the level of competition that exists in the supply of DTCS. Telstra at this stage has not considered this issue.

5.2 Market Definition

Telstra submits that in defining the relevant market, a purposive approach must be adopted. Here, the purpose of the enquiry is the assessment of whether granting the Exemption Application would be in the LTIE (see Telstra Submission, pp.17-22)

In addition, Telstra’s Exemption Application relies upon the Commission’s own criterion for sufficient competition in respect of the supply of DTCS on a particular route, as adopted in its 2004 Final Report (see Telstra Submission, pp.4-5; 2004 Final Report, p.27). Telstra therefore does not consider it necessary to adopt any definitive view on the market. However, it is prepared to adopt the views on markets expressed by the Commission in its 2004 Final Report as that they are presumably consistent with the Commission’s own criterion for sufficient competition.

What are the relevant markets that would be affected by the granting of the exemption?

In its 2004 Final Report, the Commission considered that (see 2004 Final Report, p.22):

“the relevant downstream markets for the transmission capacity service are national long distance, international call, data and IP-related markets, mobile and local call markets”

Telstra does not consider it necessary to form a definitive view on the issue for the reasons set out above. Indeed, Telstra considers that downstream markets could be broader. However, it is willing to adopt this view for the purposes of the current enquiry.

What are the substitutes for DTCS? Can microwave, satellite, submarine cable, or other technologies be considered adequate substitutes for DTCS in all or most cases?

In its 2004 Final Report, the Commission considered that (see 2004 Final Report, p.22):

“although there are a range of technological substitutes for the supply of transmission capacity services, optical fibre remains the most suitable technology for intercapital transmission services and for major non-intercapital transmission services”

Telstra considers that, in many cases, transmission supplied over microwave and satellite is substitutable for DTCS supplied over fibre. However, even if transmission over microwave and satellite were deemed not to be perfect substitutes on a particular route or market, that has no bearing on the case for granting Telstra’s application for exemption over the 20 capital-regional routes where there are at least 3 optical fibre operators. Consideration of other technologies simply demonstrates that the Exemption Application is likely to be conservative and that there are additional routes that are effectively competitive but not included in the Exemption Application.

Is the 5% Rule reasonable in the context of the exemption application? Are there any issues with the assumptions used by Telstra in deriving the 5% Rule?

As set out at pages 7 to 8 of Telstra’s Submission, Telstra considers the 5% rule to be appropriate and reasonable for the purposes of the Exemption Application as it is both economically sound (for the reasons set out at pages 7 to 9 of the Mike Smart Report) and readily capable of application. Moreover, it should not necessarily be viewed as a new rule proposed by Telstra. Rather, it reflects an extension and codification of the reasoning that the Commission itself articulated in its 2004 Final Report.

In the 2004 Report, the Commission applied a criterion of “at least three optical fibre providers, including Leighton/Nextgen as a potential provider (where its network is within 1

km or less from the GPO ...) ... as evidence of sufficient competition/contestability to warrant removal of [a] route from declaration”¹. Later in that report, the Commission explained its reason for accepting Leighton/Nextgen as a potential provider in the following way²:

“In relation to capital-regional routes, the Commission has advice that where the Nextgen network passes 1 km from a regional centre it would cost around \$50,000 to run a fibre into that town and around \$50,000 more to establish a switch facility (multiplexer or MUX) and support infrastructure, plus the costs of accommodation. The Commission considers that these costs are relatively small in comparison to the costs of the initial investments involved to construct the intercapital components of the network.”

The underlying logic for accepting Nextgen as a potential competitor is that the additional cost to Nextgen of extending its network is small relative to the cost of constructing the intercapital components of its network. The “5% Rule” is simply an application of this logic - i.e., that the relative cost of extending a potential provider’s transmission network is what matters, not the absolute cost. Since distance is a key driver of cost, it is the distance from the GPO relative to the length of the capital-regional route that matters, not the absolute distance.

In the 2004 Report, the Commission concluded that any infrastructure within 1 km of the GPO would meet this relative cost criteria. Using a formal Critical Loss Analysis (explained at pages 1 to 3 of the Mike Smart Report), Mike Smart has translated the relative cost criteria into a relative distance rule, being the “5% Rule”.

Accordingly, the “5% Rule” is not a radical departure from the criteria employed by the Commission in its 2004 Report, so much as a rigorous and principled application of them across a number of routes.

In addition, pages 7 to 9 of the Mike Smart Report set out the conservative assumptions which underlie the 5% Rule. In particular, at page 9, Mike Smart states that:

“I note that my calculation has included a number of conservative assumptions, one of which is a 5% SSNIP. A 10% SSNIP is also routinely used in market definition exercises, so the possibility should not be dismissed that any carrier with a fibre network within a distance of 10% of the route distance should be counted as a competitor in the market.”

Are there any issues with the methodology used by Market Clarity to generate the distances between capital and regional areas?

¹ ACCC (2004), p 27

² ACCC (2004), p 32

Market Clarity used “road distance” to calculate the distance between a capital city and a regional centre. Road distance is an unbiased approximation of the actual length of optical fibre cables between the capital city and regional centre for the reasons set out in the witness statement at Annexure 3 to the Telstra Submission.

Furthermore, the Market Clarity competitor count at each regional centre is conservative in that it is confined only to optical fibre operators with a Point of Presence (“POP”) within the distance dictated by the 5% Rule. There may be other optical fibre operators within that distance which are omitted by Market Clarity’s methodology because they do not have any POP there.

Please include other comments on whether Telstra’s approach to defining its exemption application area is an appropriate one.

Telstra’s approach is not materially different to the Commission’s 2004 approach, which is that the market should not be limited to existing suppliers of transmission, but include potential suppliers of transmission, provided any additional cost of supplying transmission is sufficiently low to act as a competitive constraint on the supply of transmission in that area. Critical Loss Analysis is a tool for defining the Exempt Regional Routes in a formal manner based on the Commission’s approach.

5.3 Promotion of Competition

Structural factors

In the absence of a declared DTCS in the exemption areas, would competition in downstream retail markets for relevant services be effective? Is competition in downstream markets currently effective?

Downstream markets would be largely unaffected by the grant of the Exemption Application because the existence of three optical fibre networks on the relevant route means that competition in the wholesale transmission market is effective. Accordingly, transmission prices should not increase post exemption (see Telstra Submissions, pp.11-12).

What alternative DTCS providers to Telstra currently operate in the nominated capital-regional routes? What technologies do these alternative providers use? Do these providers offer any significant competitive constraint on the pricing of the DTCS operated by Telstra? Please provide evidence of competition, such as price movements in the exemption areas.

The Market Clarity report lists the number of optical fibre based competitors that operate in (or at least have the potential to operate in) the nominated capital-regional routes. They are listed at pages 9 to 10 of the Market Clarity Report. However, as the Market Clarity Report is confined to optical fibre networks, there may be other suppliers of transmission over the

Exempt Regional Routes, using microwave links, or satellite technology. This would only further enhance the case for exemption.

In the absence of access to a declared DTCS in the proposed exemption area, would such firms provide a meaningful constraint on the pricing of the DTCS or equivalent services?

Telstra considers that the competing firms it has identified on the Exempt Regional Routes would constrain pricing of DTCS or equivalent services in the absence of declaration (for the reasons set out at pages 11-12 of the Telstra Submission and below).

For each of the capital-regional routes for which Telstra seeks exemption, there will be at least two other optical fibre operators. As set out at pages 4 to and 10 to 11 of Telstra's Submission, the presence of at least three optical fibre operators is a sufficient (but not necessary) condition for effective competition - i.e., competition that ensures "a meaningful constraint" on the pricing of transmission over the relevant routes. Consequently, if Telstra sought to raise its DTCS prices, then customers would likely shift to these alternative optical fibre networks instead (or continue to acquire DTCS from those suppliers).

Would Telstra be likely to continue to supply the DTCS if the exemption applications were granted?

The presence of at least two competitors to Telstra on each Exempt Regional Route, and the significant upfront investment, excess capacity and low incremental costs associated with optical fibre networks constrain Telstra from discontinuing the supply of DTCS (see Telstra Submission, pp.10-11). Consequently, Telstra would be likely to continue to supply the DTCS if the Exemption Applications were granted..

What infrastructure do alternative wholesale providers use?

Alternative wholesalers clearly use optical fibre networks (see Telstra Submission, pp.4-5, 8-9, and the Market Clarity Report). Other substitutes such as microwave and satellite may also be used.

Potential for competition

Are there any investments planned by alternative providers for the exemption area? How cautiously should the ACCC regard these planned deployments?

Telstra is, generally, not privy to the investment plans of other carriers and carriage service providers. However, it is a matter of public record that the Opel joint venture between SingTel Optus and Elders intends to invest in infrastructure in regional areas, and that these investments will be supported by public funding. (Public funding implies that the Opel

investments will go ahead, even if they are not strictly commercially viable).

Of course, the case for exempting transmission over the capital-regional routes applied for by Telstra does not depend on planned deployments by Opel or any other operators because it relies on existing competitive optical fibre networks.

Would all new DTCS infrastructure have the capacity to provide competitive constraints on existing infrastructure?

Optical fibre infrastructure is typically built with large capacity. The built capacity will usually be sufficient to support not just current demand for transmission traffic, but future growth in demand for transmission traffic. Constrained capacity is not normally a concern (see Telstra Submission, p.10).

Are Telstra's submissions about the level of competition in the nominated capital-regional routes accurate?

Telstra's Submission on the level of competition on the Exempt Regional Routes are based on the reports by Mike Smart and Market Clarity. Mike Smart is a well respected economist and data collection is a core business of Market Clarity.

On that basis, there can be little reason to doubt the accuracy of Telstra's Submission. *Are there any barriers to entry, expansion and exit not discussed in Telstra's application?*

There are no significant barriers to entry; expansion and exit not discussed in Telstra's Exemption Application (see Telstra Submission, p.11). Transmission is a "commodity product" with little (if any) switching costs (see Telstra Submission, pp.10-11).

Other issues

What conditions (if any) should be placed on the granting of the exemption applications?

Telstra does not consider that any conditions should be placed on the Exemption Application as it is based upon the Commission's own criteria for exemption and is already quite conservative.

5.4 Any-to-any connectivity

Would granting the exemption applications have any effect on any-to-any connectivity?

Given the extent of available alternative infrastructure and declared services, which provide, or are capable of providing, similar services to the DTCS, the grant of the Exemption will not affect the any-to-any connectivity of end-users. This view is consistent with the view expressed by the Commission in its 2004 Final Report (see Telstra

Supporting Submission, p.12; 2004 Final Report, p.47).

5.5 Efficient use of and investment in infrastructure

Economically efficient use of infrastructure

Would granting the exemption applications have any effect on the efficient use of infrastructure by which DTCS are provided

No. Granting the Exemption Application will promote facilities-based competition through encouraging greater investment in competing infrastructure. By contrast, preserving access regulation where workable competition exists is likely to discourage efficient infrastructure investment and use (see Telstra Submission, pp.12-13). Manifestations of this include: the truncation of returns from investment; the potential for regulatory dependence; the potential for arbitrage based on regulated access; and the asymmetry of the costs of regulation.

Furthermore, competition on the relevant capital-regional routes will remain effective due to the presence of at least 3 optical fibre operators. As a consequence, each operator will have strong incentives to maximise the use of their respective optical fibre infrastructure over the relevant capital-regional routes.

Economically efficient investment in infrastructure

Would granting the exemptions significantly affect Telstra's incentives to invest in its infrastructure?

Ex ante regulation has the effect of discouraging investment in infrastructure (see Telstra Submission, pp.12-13). This is because ex ante regulation has an asymmetric effect on returns. An investor is prevented from earning above normal returns during "good years", but not compensated for below normal returns during "bad years".

Granting the exemption would help to minimise this effect in respect of the relevant capital-regional routes, but not remove it altogether so long as there remains a threat to re-regulate those routes.

Since an exemption order would not harm the existing competition from optical fibre networks, but would also reduce the incidence of regulatory error, it would promote efficient investment in infrastructure, including Telstra's investment in its own infrastructure. Thus, granting the Exemption Application can be expected to improve Telstra's incentives to invest in its own infrastructure.

Would granting the exemptions affect Telstra's plans to invest in maintenance, improvement and expansion of its fixed network infrastructure?

Given that granting the Exemption Application would remove several disincentives to invest, such as the truncation of returns and the asymmetric impact of regulated prices, Telstra would be likely to face enhanced incentives to maintain, improve and expand its fixed network infrastructure. More broadly a clear signal by the Commission that it will roll back access regulation where it no longer promotes the long term interest of end users, would be likely to enhance access providers' (including Telstra's) incentives to upgrade and invest in their infrastructure.

Has declaration of the DTCS discouraged investment in alternative infrastructure by access seekers?

Whilst this is not a question that Telstra is able to answer, the Commission must also consider whether continued declaration of the DTCS will lead to regulatory dependence.

In general, ex ante regulation has the effect of discouraging investment in infrastructure (see Telstra Submission, pp.12-13). This is because ex ante regulation has an asymmetric effect on returns. An investor is prevented from earning above normal returns during "good years", but not compensated for below normal returns during "bad years".

The asymmetric effect on returns applies not just to investments in infrastructure that are directly regulated, but also investments in alternative infrastructure that deliver services that are substitutes. Returns on services that are substitutes will be affected asymmetrically if one of the substitutes is subject to ex ante regulation.

Continued declaration of the DTCS will therefore discourage investment in alternative infrastructure by access seekers.

Would granting the exemption applications be likely to encourage efficient investment in alternative infrastructure by removing the scope for reliance on the declared DTCS?

Refer to the answer below.

What implications would Telstra's exemption applications have on investment by access seekers in DTCS infrastructure?

Granting the Exemption will promote facilities-based competition by encouraging greater investment in competing infrastructure. Competition at the relevant capital-regional routes is already workably competitive due to the presence of at least three optical fibre operators. Given this workable competition, the Exemption will ensure that

competitors rely less on the regulation of access to capital-regional routes, and will face greater incentives to develop more efficient technologies to compete with incumbent operators. This will facilitate a movement away from access-based competition towards facilities-based competition, which will in turn drive out inefficiency and arbitrage throughout the supply chains, delivering lower prices and greater choice to consumers in the long-run.

By contrast, preserving access regulation where workable competition exists is likely to discourage efficient infrastructure investment and use. Manifestations of this include: the truncation of returns from investment; the potential for regulatory dependence; the potential for arbitrage based on regulated access; and the asymmetry of the costs of regulation. Granting the Exemption Application would remove these regulatory costs.

Would an alternative rule be preferable as a result?

We assume the Commission is referring to the “rule” that capital-regional routes that have at least three optical fibre networks within the 5% Rule should be exempted from the DTCS declaration. This rule is conservative in that it is “sufficient, but not necessary” for competition to be effective on a specified relevant capital-regional route. Competition could be effective wherever there are at least 2 optical fibre operators at a capital regional route, or alternatively where the third optical fibre operator is within a distance from the regional centre of 10% of the distance of the relevant capital-regional route. To the extent the Commission is open to adopting an alternative rule, a more “light handed” rule would be appropriate.

Legitimate commercial interests of access provider

Would granting the exemption applications be likely to allow Telstra to recover more than is in its legitimate commercial interests?

In posing this question, the Commission is proposing a construction of section 152AB(6) that finds little support from the plain meaning of the words of this subsection, or any other part of section 152AB. The Commission appears to be advocating a “novel” or “idiosyncratic” interpretation of the words of section 152AB(6), of precisely the kind that recently received strong criticism from the High Court in *EAPL v ACCC*.³ The Court in this case overturned a regulatory decision of the Commission, on the basis that the Commission had failed to confine itself to the “primary and natural significance” of the

³ [2007] HCA 44.

words of section 8.10 of the Gas Code, but rather had based its decision on an “idiosyncratic” construction of the words of the section. Likewise in the present instance, the Commission should not interpret the phrase “legitimate commercial interests of the supplier or suppliers of the services” to connote that the subsection may be relied upon to place an upper bound on the returns earned by the service provider from the service.

The proper construction is to ask whether the service provider will be able to earn an appropriate commercial return from providing the service.

As demonstrated in the Statement of Mike Smart, workably competitive conditions prevail over Exempt Regional Routes for DTCS. Accordingly, market forces would prevent Telstra from obtaining more than a reasonable risk-adjusted return on its efficient costs.

CONCLUSION

As evidenced by the response to these questions and the material provided by Telstra in support of the Exemption Application, Telstra’s request for an exemption over the nominated 20 capital-regional routes is likely to substantially understate the level of competition that exists for the supply of the DTCS in regional areas. It is also clear that, even according to the threshold established by the Commission in 2004, as refined by Telstra using the 5% Rule, the nominated routes are subject to workably effective competition in the supply of the DTCS. Accordingly, as the supply of DTCS over these routes is not an enduring bottleneck, the Commission has every reason to promptly grant the Exemption Application.

Telstra Corporation Limited
9 November 2007