



TELSTRA CORPORATION LIMITED

Submission in response to the ACCC's Discussion Paper on Optus' 2007 Undertaking in relation to the Domestic Mobile Terminating Access Service

April 2007

1 Introduction and summary of submissions

1.1 Introduction

On 16 February 2007, Optus Mobile Pty Limited and Optus Networks Pty Limited (collectively “Optus”) provided the Australian Competition and Consumer Commission (the “Commission”) with an ordinary access undertaking that specifies the terms and conditions on which Optus will comply with its standard access obligations (“SAOs”) in respect of Optus’ domestic GSM terminating access service (“DGTAS”) for the period 1 July 2007 to 31 December 2007 inclusive (the “Undertaking”). The DGTAS is described by Optus as a subset of the declared Domestic Mobile Terminating Access Service (“MTAS”).

The Commission issued a discussion paper regarding the Undertaking on 7 March 2007 (“Discussion Paper”) and called for submissions from the public. Telstra welcomes this opportunity to comment on the Undertaking and respond to the matters raised in the Commission’s Discussion Paper.

1.2 Summary of Telstra’s submissions

Telstra submits that the Undertaking should be rejected by the Commission because the Commission cannot be satisfied that the price terms and conditions are reasonable. In particular, Telstra submits that:

- (a) It is not necessary for the purposes of determining the reasonableness of the Undertaking to reconsider the definitions of the market in which the MTAS and downstream services are supplied. In any case, both the Commission and the Australian Competition Tribunal (“Tribunal”) have already rejected Optus’ submissions on the two-sided nature of the mobile services market.
- (b) Optus must demonstrate that the price-related terms and conditions contained in the Undertaking are reasonable. In order to satisfy the Commission that a price of 12 cpm for the supply of the DGTAS is a reasonable price during the period in which the Undertaking is intended to operate, it must demonstrate that 12 cpm reflects its efficient costs of supplying that service. However, Optus has not offered any credible evidence in support of that view.
- (c) A proper consideration of all the relevant materials available to the Commission at this time (including the materials put forward by Optus) points to the conclusion that the Commission cannot be satisfied that a price of 12 cpm is a reasonable

price for supplying the DGTAS (and/or MTAS) and, indeed, is likely to significantly exceed the efficient costs of supplying the service.

- (d) In respect of the relevant statutory criteria, Optus has failed to demonstrate that a price of 12 cpm would promote competition and be in the long-term interests of end-users. Furthermore, the evidence suggests that such a price is not necessary to protect Optus' legitimate business interests and exceeds the direct costs of supplying the DGTAS (and/or the MTAS). It is also inconsistent with the legitimate interests of access seekers and the economically efficient operation of a carriage service, a telecommunication network or a facility.

2 Statutory criteria

2.1 Application of the statutory criteria to the Undertaking

Where an ordinary access undertaking is provided to the Commission under Part XIC of the Trade Practices Act (Cth) 1974 (Cwlth) ("TPA"), the Commission must either accept the undertaking or reject it. As the Commission has previously acknowledged, and the Tribunal has confirmed,¹ it is unable to accept an undertaking in part.

However, section 152BV(2) of the TPA provides that the Commission must not accept the undertaking unless:

- a public consultation process has been undertaken by the Commission;
- the Commission is satisfied that the undertaking is consistent with the applicable standard access obligations ("SAOs");
- the price or method of calculating price, if specified in the undertaking, is consistent with any Ministerial pricing determination;
- the Commission is satisfied that the terms and conditions in the undertaking are reasonable; and
- the undertaking expires within 3 years of it coming into operation.

¹ *Application by Vodafone Network Pty Ltd & Vodafone Australia Limited* [2007] ACompT 1 ("Vodafone Tribunal Decision") at [295].

Thus, in order to accept an undertaking, the Commission must be satisfied that all the terms and conditions it contains are reasonable.

In determining whether the terms and conditions are reasonable, the Commission must have regard to the following matters set out in section 152AH of the TPA:

- whether the terms and conditions promote the long term interests of end-users (the “LTIE”);
- the legitimate business interests of the carrier or carriage service provider concerned, and the carrier’s or carriage service provider’s investment in facilities used to supply the declared service concerned;
- the interests of persons who have rights to use the declared service concerned;
- the direct costs of providing access to the declared service concerned;
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility; and
- the economically efficient operation of a carriage service, a telecommunication network or a facility.

The LTIE is defined in section 152AB(2) of the TPA in terms of the following three objectives:

- the promotion of competition in the markets for carriage services and services supplied by users of carriage services;
- achieving any-to-any connectivity in relation to services that involve communication between end-users; and
- encouraging the economically efficient use of and investment in infrastructure.

2.2 Use of the “future with or without” test

In Appendix 1 of the Discussion Paper, the Commission specifically called for parties to address the appropriateness of the “future with or without” test against the relevant statutory criteria.

Telstra submits that the “future with or without” test should not be used as a substitute for a comprehensive or objective consideration of whether a particular thing is in LTIE. While Telstra the Tribunal considered in *Seven Networks Limited (No 4)* (2005) ATPR ¶42-056 that the “future with or without” test may provide “helpful guidance” in applying the LTIE test,² this test cannot be used to provide the ultimate or final answer to the issues posed in considering an access undertaking. This would be contrary to the Tribunal’s expressed view in that case, where it stated:³

“it should be noted that the “future with and without” test requires the forecasting of future market behaviour, competitive activity and market conduct in a particular area or region and the development of an investment. But the answer to the application of that two-fold enquiry (the future with and without the exemption) is not the ultimate or final answer to the issues posed.” (Emphasis added)

The danger of sole reliance on the “future with or without” test is that it can inadvertently lead to an analysis which does not consider whether the terms of a given undertaking are themselves reasonable, but rather whether some other terms might be more reasonable.

The Tribunal’s views in that case were also expressed in the context of its review of an exemption application rather than a decision to accept or reject an access undertaking. In fact, the Tribunal went on to state that “[i]n making this assessment we are guided by the fact that, in the words of s 152AB(2), the “particular thing” that is before us is the granting of the exemption applications **and not, for example, the terms of access offered by Telstra and Foxtel**” (Emphasis added).⁴

In any event, in the Tribunal proceedings in respect of Optus’ previous undertaking in respect of the DGTAS (lodged 23 December 2004) (“**Previous Undertaking**”), it appears that the Commission has already abandoned the “future with or without” test in the

² Cf. *Seven Networks Limited (No 4)* (2005) ATPR ¶42-056 at [119]

³ Ibid.

⁴ Ibid.

context of assessing the reasonableness of an access undertaking. Mr Beach QC appearing for the Commission stated:⁵

*“...we have considered this with and without test further, it could only, in concept, be applied to some part of 152AB in terms of promoting competition and we have taken the view that when you analyse the factual and the counter-factual that you are like a dog chasing its tail in trying to work out the two different positions. **And we have now taken the view that reasonableness doesn't require you to apply the with and without test.** And that is, I think, the position that might have been said to the Tribunal in the Telstra LSS case.”* (Emphasis added)

Telstra agrees with this view and submits that the application of a future with or without is not an appropriate tool against which to assess an ordinary access undertaking. At best, it provides limited assistance in this context.

3 The Undertaking

3.1 Price-related terms and conditions

The price upon which Optus proposes to supply the DGTAS is the primary consideration in determining whether the Undertaking is reasonable. Optus offers to supply the DGTAS at a rate of 12 cpm for the term of the Undertaking, being from the later of 1 July 2007 or the date the Commission accepts the Undertaking and to the earlier of 31 December 2007 or the termination, withdrawal or replacement of the Undertaking. As discussed in more detail below, Telstra submits that a price of 12 cpm for supply of the DGTAS has not been shown to be reasonable and therefore the Undertaking cannot be accepted.

Unlike its Previous Undertaking, which was rejected by both the Commission and the Tribunal,⁶ Optus has not provided a cost model in support of the price contained in its Undertaking. Rather, Optus has sought to justify a price of 12 cpm on the basis that it is:

⁵ No ACT 3 of 2006, Transcript of Proceedings, 30 August 2006, p. 591. Goldberg J of the Tribunal then went on to confirm that the Commission's view was indeed consistent with what was said in the Tribunal proceedings in respect of Telstra's LSS undertaking.

⁶ In support of its Previous Undertaking, Optus commissioned CRA International (previously Charles River Associates) (“CRA”) to construct a cost model on its behalf. Both the Commission and the Tribunal found a number of serious defects in the model which led to their respective decisions to reject the Previous Undertaking.

- consistent with the Commission’s current pricing principles determination for the MTAS (“**Current Pricing Principles**”) (although the Current Principles expire before the Undertaking is able to take effect);
- consistent with the efficient cost of providing mobile termination services; and
- recognises the legitimate interests of both the access provider and the access seeker.

However, as set out below, a critical analysis of Optus’ submissions in support of its Undertaking and other available materials indicates that a price of 12 cpm for the supply of the MTAS for the period from 1 July 2007 to 31 December 2007 is clearly not reasonable.

3.2 Non-price terms and conditions

Optus states at paragraph 3.14 of its submission in support of the Undertaking (“**Optus Submission**”) that the non-price terms and conditions for its supply of the DGTAS are contained in clauses 2 and 3 of the Undertaking and schedules 1 and 3 of the Undertaking. Optus also claims that “[t]hese terms and conditions are comprehensive and unambiguous in their scope and operation”.

While Telstra acknowledges that a complete set of non-price terms and conditions is not necessary in order for an access undertaking to be “reasonable”, the provisions listed above do not comprehensively and unambiguously deal with the non-price terms and conditions on which Optus proposes to supply the DGTAS as asserted by Optus.

As stated in section 3.2 of the Discussion Paper, the Commission itself stated in respect of the non-price terms and conditions of the Undertaking:

“Other than the service description and the primacy of existing agreements, the Optus 2007 Undertaking does not expressly deal with any other non price terms and conditions.”

Nevertheless, Telstra submits that the non-price terms in the Undertaking do not give rise to any particular concerns in respect of the reasonableness criteria. Furthermore, given that schedule 3 confirms that the DGTAS will be provided on a non-discriminatory basis in accordance with the applicable SAOs, Telstra acknowledges that the Commission can be satisfied that these statements in the Undertaking are consistent with those obligations.

4 Need to demonstrate efficiency of costs

The Commission must reject an undertaking unless it is satisfied that the terms and conditions specified in the undertaking are reasonable. In this regard, it has been emphasised by the Tribunal on several occasions that, from a price perspective, the application of the reasonableness criteria and the LTIE objectives involve the efficient cost-based pricing of a declared service. Furthermore, that before an undertaking can be accepted as reasonable, it is necessary for the access provider to make a reasonable effort to establish that its costs are efficient costs.⁷ This was stressed by the Tribunal in its decision in *Telstra Corporation Limited* [2006] ACompT 4 where it stated (at [46]):⁸

“However, we would point out that whenever an access provider seeks approval of an access undertaking from the Commission which involves a consideration of a price term by comparing it with costs, it would be necessary, in order to satisfy the statutory framework, that the access provider establish that its costs are efficient costs. An access provider should also recognise that if the Commission decides against accepting the access undertaking and rejects it and the provider wishes to seek review of the Commission’s decision before the Tribunal, it would be necessary to establish before the Tribunal that its costs are efficient. It is apparent from the statutory framework that the Tribunal is limited in respect of the material to which it may give consideration as it is limited to the material which was before the Commission and any material referred to in the Commission’s decision. Put shortly, if an access provider wishes to establish before the Commission, or needs to establish before the Tribunal, that its costs are efficient, it will need to have put material to that effect before the Commission.” (Emphasis added).

In its decision in respect of Vodafone’s recently rejected MTAS undertaking, the Tribunal reaffirmed these propositions, stating that:⁹

“...we still consider that in general terms the prices in access undertakings should reflect and not exceed forward looking efficient economic costs”.

⁷ Vodafone Tribunal Decision at [60].

⁸ See further at [8], [20], [46], [85] and [172] of the same decision.

⁹ Vodafone Tribunal Decision at [45] and see also [46]-[62].

5 Market definition

In support of the Undertaking, Optus makes various submissions in relation to the definition and competitiveness of the market in which the DGTAS is provided and other downstream markets. In particular, Optus maintains that the DGTAS is supplied in a two-sided market (together with origination and subscription services) and that, as such, prices for the DGTAS may reasonably diverge from cost.¹⁰ Furthermore, that fixed-to-mobile (“FTM”) calls are provided in their own market which Optus maintains is not competitive.

Telstra submits that market definition is not relevant to the present inquiry. In any event, the majority of Optus’ submission have been rejected by the Tribunal and do not provide any support for the reasonableness of the Undertaking.

5.1 Market definition is not relevant

There is a threshold issue as to whether it is necessary to engage in an exercise of market definition for the purposes of considering an ordinary access undertaking under Part XIC of the TPA.¹¹ Telstra submits that issues in relation to market definition are not relevant in assessing the reasonableness of the Undertaking. While it is true that one of the limbs of the LTIE criterion is the promotion of competition in markets for listed services, it is questionable whether it is necessary to define those markets in order to assess the reasonableness of an ordinary access undertaking.

While market definition may be relevant when declaring a service or in the granting of an exemption under sections 152AS, 152ASA, 152AT or 152ATA of the TPA (and even then only a “general view” may be required), it is not so relevant when assessing an ordinary access undertaking.¹² In that context, the primary issue is whether a price proffered in the undertaking is reasonable for the purposes of section 152AH of the TPA.¹³ As the Tribunal has pointed out, the statutory criteria compel the establishment of prices reflective of the

¹⁰ See for example, Optus Submission paras 6.12-6.18.

¹¹ Cf. *Foxtel Management Pty Ltd v Australian Competition & Consumer Commission* (2000) 173 ALR 362 at [153]; and ACCC, *Telecommunications services - Declaration Provisions: A Guide to the Declaration Provisions of Part XIC of the Trade Practices Act*, (July 1999) p. 42.

¹² Cf. the position under Part IIIA where it is accepted that there is no need to define the market for the supply of the service that is the subject of declaration: *Services Sydney Pty Limited* [2005] ACompT 7 at [109]: “While product and geographic substitution will often be the focus of argument in Pt IV matters, this is less often so in Pt IIIA matters. The focus here tends to be not on the dimensions of the market, as defined by substitution, but on the existence of separate markets from the market for the service.”

¹³ That is, from a price perspective. Obviously non-price terms will involve a consideration of other matters.

efficient costs of providing the given service.¹⁴ That is, it can readily be assumed that efficient pricing of a service will promote competition in markets for listed services without any need to clearly define those markets. This was made clear in *Seven Networks Limited (No 4)* (2005) ATPR ¶42-056 where the Tribunal stated (at [135]) that “there are some basic pricing principles that should be observed in applying the LTIE test” including that “[t]he price of a service should not exceed the minimum costs that an efficient firm will incur in the long-run in providing the service”. That principle is not dependent on market definition. As the Tribunal went on to state (at [136] and [137]):

“..in the general case where access prices need to be regulated, unless pricing is on a TSLRIC basis, efficient investment is unlikely to be encouraged. This, in turn, would fail to promote competition in the long-term....

...in our view, it would generally not be in the LTIE to depart from TSLRIC pricing where access is regulated.” (Emphasis added).

Put shortly, the Tribunal has recognised that it is efficient pricing that promotes competition for the purposes of the LTIE criterion irrespective of the precise definition of the markets in which the service is supplied.

In the present context, the relevance of market definition goes solely to the Commission’s rationale for declaring the MTAS. It has no bearing on the ultimate assessment of the Undertaking and whether the prices in the Undertaking reflect the efficient costs of supplying the DGTAS. That there is no need for the Commission to reconsider its rationale for declaring the MTAS each time it considers an ordinary access undertaking is made clear by the Explanatory Memorandum that accompanied the introduction of Part XIC of the TPA which, in discussing the “reasonableness” criteria in section 152AH, states:¹⁵

“Reference to whether the terms and conditions would promote the long-term interests of end-users of carriage services and services supplied by means of carriage services is not intended to provide grounds for reconsideration of the decision by the ACCC to declare the service to which the terms and conditions referred to in this provision relate.”

¹⁴ *Telstra Corporation Limited* (2006) ATPR ¶42-121 at [46].

¹⁵ *Explanatory Memorandum to the Trade Practices Amendment (Telecommunications) Bill 1996*, (which introduced Part XIC to the TPA) p. 42.

5.2 The market in which the DGTAS is provided

Irrespective of the need to define markets in the present context, both the Commission and the Tribunal have already rejected Optus' submissions on the purported two-sided nature of the market in which the DGTAS is provided. Since that consideration, Optus has not provided any new evidence or raised additional matters in the Optus Submission in support of its continued advocacy of a two-sided MTAS market. In its final decision to reject the Previous Undertaking, the Commission stated:¹⁶

"The Commission notes Optus's continued assertion that the MTAS - and therefore its DGTAS - is supplied with the broader (two-sided cluster) mobile services market. However, the further arguments put forward by Optus in this regard have not dissuaded the Commission from the view it expressed in the MTAS Final Report. In the MTAS Final Report the Commission stated:

... MNOs have control over access to termination of calls to subscribers on their network. As a result of this, the Commission does not believe that MTASs provided on different mobile networks are substitutable for each other – calls to a consumer connected to one mobile carrier's network cannot be terminated on another carrier's network. Further, there are no adequate demand- or supply-side substitutes that will constrain mobile network operators in their pricing decisions for the mobile termination service. These factors, combined with a lack of consumer awareness (on the part of both the A- and B-party consumers) and the incentives that arise from the CPP principle that governs calls to mobile networks, fails to mitigate the control over access mobile operators have with regard to calls terminating on their networks."

This was echoed by the submissions of the Commission in the subsequent Tribunal proceedings in relation to the Previous Undertaking. In that context, the Tribunal rejected Optus' submission that the MTAS (and /or the DGTAS) is supplied in a two-sided market by defining the market as one for the supply of the wholesale MTAS by Optus. The Tribunal stated in *Application by Optus Mobile Pty Limited & Optus Networks Pty Limited* [2006] A CompT 8 ("**Optus Tribunal Decision**") (at paragraph [80]):

"Accordingly, we lean towards the Commission's view of the appropriate market definitions. It is correct to identify a wholesale market for the supply of Optus' MTAS. There are no substitutable products and the relevant market transaction is a wholesale transaction provided by one network operator to another. To the extent

¹⁶ ACCC, *Optus's undertaking with respect to the supply of its Domestic GSM Terminating Access Service (DGTAS): Final Decision (public version)*, (February 2006) ("**Previous Undertaking Decision**"), pp. 140-141.

to which there is substitutability of products or services it is the bundle of services which is substitutable; one of the services is not substitutable for another of the services.”

Much of the Optus Submission elides any proper consideration of the functional level within which the MTAS (and/or the DGTAS) is supplied and the substitution possibilities within that functional level. However, as one commentator has observed: “the functional aspect is the hinge upon which the definition of markets turns because it determines the buyers and sellers who meet each other with the same competitive interest”.¹⁷ Optus has itself noted in another context, there are wholesale and retail functional levels for the provision of mobile services and it is important to identify the vertical stages of production and/or distribution that comprise the relevant arena of competition. Furthermore, this involves a consideration of both the efficiencies of vertical integration, commercial reality and substitution possibilities at adjacent vertical stages.¹⁸ Curiously, Optus does not attempt to undertake that task in the present context.

The DGTAS is supplied at the wholesale level as an isolated service and not as part of any bundle. In order to overcome this fact, Optus seeks to collapse the retail and wholesale functional levels for the supply of the DGTAS in support of the existence of a ‘two-sided market’. It is worth noting that the example cited by Optus (based on the Federal Court’s decision in *Australian Competition and Consumer Commission v Rural Press Limited* (2001) ATPR 41-084) relates to a two-sided market at the one functional level, and is otherwise divorced from the purpose of the present inquiry, providing no support at all for Optus’ position.

This issue was also considered in the Commission’s final decision to declare the MTAS in relation to the product dimension of the market where it was stated:¹⁹

“The Commission does not believe ... that the MTAS should be considered as being supplied as part of the same cluster of retail mobile services for the purposes of this inquiry. While the Commission agrees there are some complementarities in demand and supply with regard to the MTAS and retail mobile services, the Commission considers that the MTAS (as opposed to the ability to receive calls) is

¹⁷ Heydon, *Trade Practices Law*, Law Book Company, at para [3.610].

¹⁸ Optus, *Optus Submission to Australian Competition and Consumer Commission on Mobile services*, (June 2003) (“**Optus MSR Submission**”), para 6.17.

¹⁹ ACCC, *Mobile Services Review: Mobile Terminating Access Service - Final Decision on whether or not the Commission should extend, vary or revoke its existing declaration of the mobile terminating access service*, (June 2004) (“**MTAS Final Decision**”), p. 46.

not being sold in the same bundle as other mobile services sold at the retail level to mobile subscribers. This is because the MTAS is clearly a wholesale service sold to other network operators, while retail mobile services are sold directly to a different group of end-users. That is, while the mobile subscriber pays for outgoing calls and subscription, under a CPP model, it is the party originating MTM and FTM calls that pays (indirectly) for termination services when its carrier purchases terminating access services in order to provide FTM and MTM calls. While the provision of a MTAS provides benefits to both the maker and receiver of a call (and is therefore jointly consumed), it is not paid for by both consumers and is not sold to retail mobile consumers. On this basis, the Commission believes that the relevant product for the purposes of this inquiry is not a retail bundle (or cluster) of mobile telephony services. Rather, it is merely the MTAS alone.”

Optus' presentation of a two-sided "mobile services market" ignores another key aspect of the market in which the DGTAS is supplied. It is suggested by Optus that the DGTAS is supplied in a two-sided market because mobile service providers supply customers with a bundle of subscription, origination and termination services. However, if correct, this analysis should equally apply to a fixed customer, who also obtains the right to terminate on the mobile networks when purchasing the fixed retail service. Yet it is clear that fixed customers do not acquire the DGTAS as part of a bundle including mobile subscription and mobile origination services. This is significant given that it is clear that a significant percentage of the minutes terminated using the DGTAS originate from fixed customers. This highlights that the DGTAS is really a wholesale input that is supplied to access seekers, and which ultimately forms part of the service provided to fixed and mobile end-users on all networks. Seeking to focus only on the relationship between the DGTAS and the supply of mobile services to end-users leads to a "disembodied" picture of the market which ignores both the fixed-line customer and access seekers as acquirers of the DGTAS.

This omission is significant in relation to Optus' submissions on price setting in two-sided markets. In essence, Optus maintains that it is reasonable to price above cost for the DGTAS because subscription and origination services will likely be priced below cost. Whether or not this is necessarily true, latent in this submission is that the fixed-line customer - when making a fixed-to-mobile call - should subsidise the mobile subscriptions of Optus' mobile customers. It is by no means clear that such subsidisation is efficient or will promote efficient investment in fixed line infrastructure in circumstances where fixed line penetration is declining and mobile penetration is at or near saturation.

5.3 Market in which fixed to mobile calls are provided

In the Optus Submission, while recognising that FTM calls are invariably provided together with a basket of fixed-line services such as long distance and international calls, Optus nevertheless contends that:²⁰

“...fixed to mobile services are supplied in a separate market to long distance and international. Even though there are complementarities in the demand for the bundle of services, it may be that operators can compete on single services, such as by offering calling cards and over-ride codes.”

However, as with its submissions on the two-sided nature of the “mobile services market”, Optus has not provided any evidence to support its assertions.

Telstra submits that FTM services are almost invariably provided together with a basket of fixed line services as follows:

- (a) “Price Control Basket” - FTM calls are commonly provided and priced as part of a basket of fixed-line services including line rental, long distance, international, local and FTM calls (the “Call Basket”). In addition, the prices Telstra charges for retail fixed-line telephone services are subject to price caps under the retail price control arrangements (“Retail Price Controls”).²¹ Under the Retail Price Controls, FTM calls are a component service within the Call Basket which are subject to a price cap of CPI-CPI - in effect imposing an overall price freeze (and an effective price decrease) on a basket of services including all line rentals, long distance, international, local and FTM calls.
- (b) “Pre-Select Basket” - under the pre-selection arrangements, FTM Calls are provided as part of a basket of pre-selected services by which end-users must choose a single service provider for all long distance, international and FTM calls.²² The Pre-Select Basket is narrower than the Call Basket adopted in the Retail Price Controls in that it does not include local calls and line rental.

There are strong complementarities in supply that exist in relation to FTM services and other services in the Price Control Basket (and the Pre-Select Basket). Telecommunications

²⁰ Optus Submission, paras 6.21-6.22.

²¹ *Telstra Carrier Charges – Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2005.*

²² MTAS Final Decision, p. 59.

operators compete with each other across the Call Basket (or the Pre-Select Basket) rather than on the basis of the price for individual call types within those baskets (such as FTM calls). These complementarities in supply are echoed on the demand side. That is, when an end-user acquires fixed line services they do not simply want to be able to make calls to mobile users. They also want to be able to call other local fixed line users and make long distance and international calls. The provision of these services also requires the provision of line rental services.

In the MTAS Final Decision, the Commission concluded that FTM calls are provided in a market together with other services offered in a basket of pre-selected services due to strong complementarities of supply. The Commission stated:²³

“...[FTM calls, national and long distance calls] are considered to be part of the same bundle of services because of complementarities in their provision and because they are offered as a bundle in pre-selection offerings by carriers.

...

Overall, therefore, the Commission considers the relevant market within which FTM calls are provided is likely to be a national market for the provision of the pre-selected bundle of FTM, national long distance and international calls at the retail level. It is noted that the FTM service is provided in a downstream market of the MTAS markets, and is likely to be provided in the same market as national long-distance and international calls.”

Moreover, mobile services and alternative delivery technologies are increasingly becoming substitutable for fixed-line services. These issues are discussed further in section 7.3 below.

6 Efficient use of and investment in infrastructure

As discussed above, before the Commission can accept the Undertaking, it must be satisfied from the available material that the price contained in the Undertaking reflects the efficient costs of supplying the DGTAS. Such a price is consistent with the object of encouraging the efficient use of and investment in infrastructure. However, as discussed in more detail below, it is clear from the information available to the Commission that a price of 12 cpm is likely to substantially overstate the efficient costs of supply.

²³ MTAS Final Decision, pp. 59 and 60.

Optus claims that a DGTAS price of 12 cpm for the period 1 July 2007 to 31 December 2007 is a reasonable estimate of the efficient cost of providing the MTAS.²⁴ Optus offers two main sources of information in support of this contention:

- (a) the Current Pricing Principles; and
- (b) various international benchmarks.

Telstra responds to each of these in turn below. However, at the outset, Telstra notes that Optus has admitted that it does not know whether 12 cpm represents the efficient cost of supply of the MTAS. Optus states at paragraph 7.3 of the Optus Submission:

“Neither the Commission nor Optus has finalised a view as to the TSLRIC modelling using bottom up modelling. It is uncertain as to whether 12 cent [sic] per minute is above, at or below cost.”

Therefore, Optus’ submission that a price of 12 cpm reflects the efficient cost of supply lacks credibility. Telstra submits that, given Optus’ express recognition that it is uncertain as to the costs of supplying the DGTAS²⁵ (and its further acknowledgment that these costs may be below 12 cpm), it is difficult to see how the Commission can be satisfied of the reasonableness of the Undertaking.²⁶

Telstra also considers various other sources of information that indicate that 12 cpm is likely to significantly overstate Optus’ costs of supplying the MTAS (and/or the DGTAS). In particular, a critical examination of Optus’ cost model submitted in support of its Previous Undertaking, other international benchmarks and the WIK Model developed for the Commission all confirm this view.

Moreover, it is simply not true, as Optus has asserted in paragraph 8.2 of the Optus Submission, that the Tribunal has determined that “MTAS prices above cost may promote competition”. This is a fundamental misunderstanding of the Tribunal’s decision. What the Tribunal concluded was that MTAS prices above cost may not necessarily be “unreasonable”, provided that the overall charge for all relevant services does not exceed the efficient costs of supply of those services.²⁷ It has never said that prices above cost will promote competition and Optus has not submitted any evidence in relation to the level of

²⁴ Optus Submission, para 8.1.

²⁵ Optus Submission, para 8.2.

²⁶ *Telstra Corporation Limited* (2006) ATPR 42-121 at [20], [85] and [172]; *Re Seven Networks (No 4)* (2005) ATPR 42-056 at [330].

²⁷ Optus Tribunal Decision at [82].

its overall charges. This issue is discussed further in section 7.1 of this submission in relation to the promotion of competition.

6.1 Current Pricing Principles

Optus claims that the Current Pricing Principles support a price of 12 cpm for the period of its Undertaking. This is not the case. The Undertaking specifies that its commencement date is the later of 1 July 2007 and the date the Commission accepts the Undertaking. The Current Pricing Principles expire on 30 June 2007 and are not effective beyond this date. The Commission could have, had it wanted to at the time, extended the expiry date of the Current Pricing Principles to 31 December 2007 so that the indicative price of 12 cpm would apply for the whole of calendar year 2007, including the period covered by the Undertaking. However, it chose not to do so, preferring to end the Current Pricing Principles halfway through the year and develop a new set of pricing principles (see section 6.3 below). As the Commission concluded in its decision to declare the MTAS:²⁸

“Given the dynamic nature of the telecommunications industry, the Commission believes it appropriate in this instance that its pricing principle apply for no more than three years. Accordingly, the Commission believes its pricing principle should apply until 30 June 2007.”

Given the more recent materials available to the Commission as discussed below, it would not be appropriate, as Optus submits, for the Commission to simply continue to rely on the old framework behind the Current Pricing Principles, especially when they would have expired by the time the Undertaking is set to come into effect.

To the contrary, Telstra submits that the Commission’s previous analysis in developing the Current Pricing Principles in fact suggests that the efficient costs of supplying the MTAS could be significantly below 12 cpm.

In its final decision to declare the MTAS, the Commission concluded that the TSLRIC+ of mobile termination “is likely to lie within the range of 5 to 12 cpm.”²⁹ The target price of 12 cpm stipulated in the Current Pricing Principles was said to represent the Commission’s conservative “upper bound” TSLRIC+ estimate of supplying the MTAS based on the information available to it at the time. That was in June 2004.

²⁸ MTAS Final Decision, pp. 220-221.

²⁹ MTAS Final Decision, p. 238.

Indeed, in selecting the target price adopted in the Current Pricing Principles, the Commission expressly recognised that it could well have been adopting “a target price above existing TSLRIC+ levels (and possibly even further above what TSLRIC+ will be in 3 years time)”.³⁰

In summary, Telstra submits that the Current Pricing Principles do not support Optus’ contention that 12 cpm reflects its efficient costs of supplying the DGTAS during the period in which the Undertaking will operate. The Commission has itself indicated that it did not regard the Current Pricing Principles as reliable beyond 30 June 2007 and in those circumstances Optus’ reliance on those principles in the present context is misplaced.

6.2 International benchmarking analysis

Optus offers several international benchmarks in support of its submission that a price of 12 cpm is a reasonable estimate of efficient costs. Telstra makes three observations in this regard.

First, the utility of international benchmarks in ascertaining the efficient costs of supplying the MTAS in Australia has been subject to serious challenge by the Tribunal. In the Optus Tribunal Decision, the Tribunal heavily criticised the international benchmarking analysis conducted by CRA on behalf of Optus. The Tribunal stated (at [295]-[296]):

“CRA’s international benchmarking report was considered by Marsden Jacob Associates. They concluded that there were other countries which should have been included in the analysis, such as Israel, South Korea and the United States. They undertook a simple benchmarking approach by calculating standard per minute charges in a common currency and came up with a comparison whereby only a few estimates exceeded 12 cpm. Their benchmarking approach did not take into account any of the adjustments made by CRA or the other adjustments which Telstra and the Commission said should be taken into account. Nevertheless, this demonstrates that a benchmarking analysis of other countries tells us little about the reasonableness of prices charged in the Australian regulatory environment.” (Emphasis added)

The Tribunal then concluded (at [297]):

³⁰ MTAS Final Decision, p. 215.

“In any event, the nature of the international benchmarking exercise was such that it teaches very little, or nothing at all, as to whether Optus’ price terms are reasonable having regard to the matters set out in s 152AH and the objectives in s 152AB. In order to place any reliance upon the international benchmarking analysis it would be necessary to know much more about the regulatory environment within which they were determined, the state of the relevant markets and the socio-economic environment in which the mobile services were operative.”

Accordingly, Optus’ benchmarking analysis needs to be considered with caution. Furthermore, all of the specific criticisms made by the Tribunal in respect of Optus’ benchmarking analysis submitted in support of its Previous Undertaking apply equally to that submitted in support of the Undertaking. The range of prices derived is so broad as to be of little assistance. No information is provided about the regulatory environment within which the various benchmarks were determined, the state of the relevant markets or the socio-economic environment in which the mobile services were operative. Optus has not attempted to make any adjustments to the international benchmarks it has offered in support of 12 cpm. Nor has it sought to include benchmarks from jurisdictions where the MTAS price is significantly lower than 12 cpm. For example, of some of the more recent examples recognised by the Commission, it is indicated that results from Israel yielded an estimate for the MTAS equivalent to 5.45 cpm and results from South Korea produced an estimate of 4.49 cpm.³¹

Secondly, even if the Commission were to accept international benchmarking as probative in the context of considering the reasonableness of the Undertaking, the available evidence in fact suggest the opposite - that is, the current price of supply of the MTAS in Australia (ie 12 cpm) is too high and is likely to be above efficient costs.

This was expressly acknowledged in the Previous Undertaking Decision, where the Commission stated (at p. 124):

“...at this stage, there is still no credible or relevant cost estimate available above 12 cpm when adjusted to Australian currency. An international cost benchmarking analysis which includes cost estimates from the increasing number of jurisdictions where transparent bottom-up cost models have been developed (i.e. New York, California, Florida, UK, Sweden, Malaysia, South Korea and Israel), and adjusting for

³¹ See Previous Undertaking Decision, p. 123.

exchange rates differences, yields a range of 4 to 12 cpm for supplying the MTAS in Australia, with more recent estimates tending towards the lower end of the range.”
(Emphasis Added)

Moreover, a recent article from Communications Day suggested that Australia’s MTAS rates were significantly more expensive than international benchmarks:³²

“In 2005, Australia was judged to have the 76th most expensive mobile termination rates in the world in a Switzernet survey. Mobile termination prices in Singapore, Optus’ home country, are less than one Australian cent per minute and are only slightly higher in Hong Kong and China.” (Emphasis added)

The above evidence tends to suggest that a price of 12 cpm cannot be regarded as reflective of the efficient costs of supplying the MTAS (and/or the DGTAS). The information discussed in this section indicates that an estimate closer to 5-6 cpm represents a more accurate estimate of the efficient costs of supplying the MTAS.

As a further note, Optus has not referenced or sourced any of the benchmarking data in Appendix II of the Optus Submission. Therefore, it is not possible for Telstra to ascertain the accuracy or relevance of the data.

Telstra also submits that there are several additional sources of information which further corroborate its view that a price of 12 cpm is above the efficient costs of supplying the MTAS. These matters are set out in the remainder of this section 6.

6.3 Adjusted prices of the CRA Model

Of particular significance in the present context is the material submitted by Optus in support of its Previous Undertaking and the Commission’s and the Tribunal’s assessment of that material in relation to Optus’ costs of supplying the DGTAS.

In particular, in support of its Previous Undertaking, Optus engaged CRA to prepare a cost model which modelled its costs based on a stand-alone mobile operator.³³ After reviewing

³² ACCC flags more cuts to mobile termination prices, Communications Day, Issue 2296 (Thursday 15 March 2007).

³³ The Previous Undertaking was rejected by the Commission on 3 February 2006. The Tribunal confirmed the Commission’s decision to reject the Previous MTAS Undertaking on 22 November 2006.

the CRA model, the Commission stated in the public version of the Previous Undertaking Decision that:³⁴

“Optus’s own [LRIC + EPMU] cost estimate appears to fit comfortably within the Commission’s previously determined range of 5 – 12 cpm. In fact, CRA’s own model reveals that Optus’s ‘LRIC+EPMU’ estimate of supplying the MTAS lies comfortably in the middle of the Commission’s estimated range.”

That statement would indicate that, based on the Optus’ own cost model, its LRIC and EPMU costs of supplying the MTAS are in the order of 8 cpm.

Furthermore, it is also significant that the cited passage does not take account of any of the empirical errors identified by the Commission and other interested parties in respect of the LRIC component of Optus’ cost estimate (based on CRA’s model), which include:

- (a) the failure to allocate any network costs to SMS and data services;
- (b) the use of inappropriate routing factors; and
- (c) the use of anchored costs and volumes.

Many of the criticisms made of these elements were accepted by the Tribunal in its review of the Commission’s decision rejecting the undertaking.³⁵ Once these and other factors are taken into account, a further reduction in the LRIC component would occur with the result that the LRIC + EPMU estimate would inevitably trend below 8 cpm.

Telstra submits that a consideration of the material provided by Optus in support of its Previous Undertaking and the Commission’s and the Tribunal assessment of that material is relevant to its assessment of the present Undertaking. Further, that the Commission should properly have regard to this material and the critical examination(s) of it previously undertaken in considering the Undertaking. Telstra submits that this evidence unequivocally suggests that a price of 12 cpm is well above Optus’ efficient costs of supplying the DGTAS. On that basis alone, the Undertaking cannot be accepted as reasonable.

³⁴ Previous Undertaking Decision, p. 120.

³⁵ See Optus Tribunal Decision at [104] to [136].

6.4 Prices generated by the WIK Model

As discussed above, the Commission has decided to develop a new set of pricing principles in respect of the MTAS that will apply from 1 July 2007 to 30 June 2009 (“**New Pricing Principles**”). To inform the making of the New Pricing Principles, the Commission engaged wik-Consult GmbH (“**WIK**”) to prepare a bottom-up cost model for the purpose of estimating the costs of supplying the MTAS in Australia (“**WIK Model**”).

On 1 February 2007, the Commission released a discussion paper (“**WIK Discussion Paper**”) and a public report on the WIK Model (“**WIK Report**”)³⁶. Telstra and other interested parties provided submissions on the WIK Discussion Paper on 16 March 2007.

The WIK Report indicates that WIK was commissioned to construct:³⁷

“a bottom-up engineering-economics cost model of the Total Service Long-Run Incremental Cost plus (TSLRIC+) of providing the termination of voice calls on mobile networks in Australia.”

The WIK Report describes the WIK Model developed in response to that commission in the following terms:³⁸

“The WIK Mobile Network and Cost Model (WIK-MNCM) is a bottom-up cost model, using a Total Service Long-Run Incremental Cost framework. The WIK-MNCM is able to determine the costs of all services provided by a mobile network, in particular the cost of terminating a call on it. The network can flexibly be configured to a hypothetical operator based on different assumptions regarding coverage and market share and for scenario applications to existing networks.”

Part 6 of the WIK Report considers the costs of supplying the MTAS under various different scenarios. Of key relevance is the “reference case” considered in the report; namely, “the hypothetical efficient operator”. This is consistent with the Tribunal’s observation in *Application by Vodafone Network Pty Ltd & Vodafone Australia Limited* [2007] ACompT 1 where it stated in relation to its consideration of the benchmark operator (at para [68]):³⁹

³⁶ WIK, *Mobile Termination Cost Model for Australia*, (January 2007).

³⁷ WIK Report, p. 1.

³⁸ WIK Report, p. 6.

³⁹ It is to be noted that, although the Tribunal did enter into some discussion in relation to the assumed characteristics of the benchmark operator, it reached no conclusions on this issue.

“The starting point in assessing the submissions on this issue is, as throughout this proceeding, the principle that prices should be based on the forward looking costs of an efficient operator. The basic objective is to set prices that promote economic efficiency, which is the outcome that could be expected in a competitive market. It is because mobile termination has been declared as a service that inherently lacks the discipline of competitive forces that it is subject to Pt XIC of the Act.”

The WIK Report adopts a similar position stating that “a typical reference point for regulatory policy decisions on the TSLRIC of a regulated service is a hypothetical operator which may be an operator newly entering the market.”⁴⁰

Adapting these principles to Australian market conditions, the WIK Report goes on to consider a “31% reference-case” for a hypothetical efficient mobile operator in Australia.⁴¹ This operator is defined by three key characteristics: (1) the efficient operator has a market share of 31 per cent; (2) the operator operates a 2G mobile network; and (3) the operator’s network is determined as a stand-alone mobile network. This last characteristic is consistent with the position adopted by the Tribunal in the Optus Tribunal Decision (at [119]-[124]).

The WIK Report goes on to indicate that the efficient mobile operator with 31 per cent market share results in an estimate for the costs of supplying the MTAS of 5.3 cpm.⁴² The WIK Report goes on to indicate that the efficient mobile operator with 25 per cent market share produces the MTAS at a cost of 5.9 cpm.⁴³

While Telstra has a number of serious concerns in relation to the WIK Model which were set out in its submissions to the Commission in that context, the WIK Model nevertheless indicates that the outputs generated by the model tend to indicate that the likely TSLRIC+ of the MTAS are well below 12 cpm and is more likely to be in the order of 5-6 cpm. Although Telstra does not endorse the WIK Model, it does recognise that its outputs are consistent with the other sources outlined in section 6 of this submission.

⁴⁰ WIK Report, p. 118.

⁴¹ See Telstra, *Submission in response to the ACCC’s Discussion Paper on the WIK Mobile Network and Cost Model to inform the MTAS Pricing Principles Determination 1 July 2007 to 30 June 2009*, (March 2007) as to why the 31% reference case is the appropriate reference case to adopt in considering the WIK Model’s outputs.

⁴² WIK Report, p. 124.

⁴³ WIK Report, p. 121.

7 Promotion of competition

Part of the Commission's consideration of the LTIE criterion is whether the price contained in the Undertaking will promote competition in relevant markets. Optus has submitted in paragraph 7.1 of the Optus Submission that a price of 12 cpm will promote competition and relies on several materials in support of this view. These materials and related issues are considered below in turn.

7.1 Consideration of overall charges

Optus cites the Tribunal at paragraph 7.2 of the Optus Submission in support of the contention that, in considering the reasonableness of an access price of a service, regard must be given to the overall revenue of the carrier in providing all relevant services. Telstra makes two submissions in response.

First, the Tribunal did not establish any necessary link between an above cost access price being reasonable and the interaction of the declared service with retail services. What the Tribunal said was:

"If Optus' DGTAS is supplied at a price which exceeds the efficient costs of supply of that service, it does not necessarily follow that such price is unreasonable".

The Tribunal then went on to stress that, nevertheless, an access price above efficient costs would generally not be reasonable.

Secondly, and more importantly, the Tribunal stressed that an above cost price "may not be" (not must not be) "unreasonable where the overall charge for all the relevant services does not exceed the efficient costs of supplying of those services [viz the other retail services and the declared service]". Optus has not provided any evidence to suggest that its overall charges for all relevant services do not exceed efficient costs. Accordingly, there is no basis on which to deviate from the general position that access price should be cost based.

Optus also contends at paragraph 7.4 of the Optus Submission that its overall charge for mobile services is "constrained by vigorous competition in the retail market for mobile services". The Tribunal has already rejected this argument in the Optus Tribunal Decision (at [85]):

"Even if the retail mobile services market were effectively competitive we do not consider that Optus would be strongly constrained in setting its DGTAS price by competition in the retail market. The mobile operators could set their termination

charges on a reciprocal basis at above cost while still competing vigorously in the retail market. Indeed, it was accepted that that is what they do.”

Further, Optus has submitted that the reductions in MTAS rates have “significantly reduced” its earnings from its mobile business and caused a “significant financial impact”.⁴⁴ Optus’ focus on revenue in this context is misplaced. As discussed above, the statutory criteria direct primary attention to efficient cost based pricing. It goes without saying that any move from higher prices to efficient cost based pricing will likely result in a loss in revenue for a given access provider. That does not in itself provide justification for not moving towards efficient cost based pricing.

In any case, the financial impact of reduced MTAS rates appear to have been overstated by Optus as it seems to have ignored the benefits of reduced prices, such as increasing call volumes. As a recent article pointed out:⁴⁵

*“...despite a 22% cut in regulated per minute rates last year, Optus’s latest results reported just a 2% drop in incoming services revenue, **which implies that rising call volumes are almost cancelling out the reduced rates.** Incoming mobile revenues are worth over \$850m a year to Optus.”* (Emphasis added)

7.2 Effect of further reduction in MTAS rates on competition

Paragraph 7.7 of the Optus Submission states that further reductions in MTAS prices for the period of the Undertaking are “unlikely to promote competition in the market(s) for fixed telephony services”. This view rests on a misconception of the LTIE criterion and is directly inconsistent with Optus’ own assessment of the criterion as set out in paragraphs 6.23 to 6.30 of the Optus Submission where it emphasised that the objective of promoting competition involves the idea of creating the conditions or environment for improving competition and does not require demonstration that there will in fact be an actual advance in competition. It is efficient, cost based pricing of the MTAS that puts in place the necessary conditions for improving competition. This may occur across a basket of fixed-line services or in forms other than price.

Optus’ submission also establishes a point of false comparison. The object of the present inquiry is not whether prices different to those contained in the Undertaking would be

⁴⁴ Optus Submission, paras 7.4 and 7.5.

⁴⁵ *ACCC flags more cuts to mobile termination prices*, Communications Day, Issue 2296 (Thursday 15 March 2007).

likely to promote competition over the period of the Undertaking. It is whether or not the price terms and conditions specified in the Undertaking are themselves reasonable. As discussed, there is no basis on which the Commission could be satisfied that the 12 cpm price adopted in the Undertaking reflects the efficient costs of supplying the MTAS (and/or the DGTAS). This conclusion does not involve a comparison of the price adopted in the Undertaking with alternative prices.

7.3 Telstra's ownership of the local loop

Access to the local loop

In paragraph 7.8 of the Optus Submission, Optus maintains that competition in the fixed line market is affected by Telstra's control of the local loop. This submission is at best a distraction and is wholly irrelevant to the consideration of the reasonableness of the Undertaking. In essence it seeks to advance the proposition that competition will not be promoted in a downstream market because of the alleged position of Telstra in that market. However, as the Tribunal stated in its decision in respect of the Previous Undertaking:⁴⁶

"...operators in the fixed-to-mobile market – and in particular Telstra – may obtain some degree of windfall gains from lower mobile termination charges. (It might be expected that Optus' DGTAS charges would ultimately be lower as a result of Optus' undertaking not being accepted.) This is not sufficient in itself to justify DGTAS charges higher than those based on efficient costs. Even if Telstra were in a pure monopoly position in the fixed-to-mobile market, it would pass on to its customers some (it was argued at least half) of any lowering in its costs, for example, from lower payments to Optus for purchases of its DGTAS. This would result merely from profit-maximising behaviour: it can easily be shown that failure to pass on part of a cost reduction would result in lower sales and hence revenues more than offsetting the reduction in costs."

In any event, Telstra's ownership of the local loop does not prevent its competitors gaining access to the local loop. Competitors can provide FTM calls (and other fixed line services) using a number of declared services including the ULLS and PSTN originating and terminating access. The Commission has adopted a TSLRIC based pricing principle for each

⁴⁶ Optus Tribunal Decision at [89].

of the ULLS and PSTN originating and terminating access services.⁴⁷ In addition, unregulated wholesale resale services are also available for the provision of various services in the call basket.

The Commission has recently recognised the increase in quasi-facilities based competition using the ULLS. In the Commission's *Declaration inquiry for the ULLS, PSTN OTA and CLLS: Final Determination* (July 2006) it is stated (at p. 16):⁴⁸

"Quasi facilities-based competition is comparably more developed. This form of competition predominantly relies on the ULLS, which enables competitors to install their own DSLAMs in Telstra's exchanges and offer both broadband and voice services. The line sharing service (LSS) is a similar service, though only provides access to part of the copper line. It is used by competitors to provide broadband services only, with standard voice services being provided by a separate operator.

After several years of slow take-up, the level of quasi facilities-based competition is increasing. Several carriers have signalled their intention to take-up large numbers of ULLS as part of plans to install their own DSLAMs for the provision of xDSL products. Industry analysts recently reported that Optus, iiNet, and Primus are currently undertaking national deployments of DSL infrastructure, and estimated that by the end of 2006, these carriers will have deployed around 200,000 DSL ports. It also appears that several niche ISPs are installing DSLAMs in regional areas."

Because of the availability of the ULLS and the other services referred to above, there are a number of ways that competitors are able to compete with Telstra in the provision of fixed-line services (including FTM calls). The availability of these services has allowed competitors to "piggyback" onto Telstra's PSTN network.

It is significant that the Optus Submission does not discuss quasi-facilities based competition based on the availability of ULLS. Rather, the Optus Submission simply asserts that the "economics of fixed telephony resale has made competitors with resale as their primary means of competing in the market ineffective". While Telstra disputes the veracity of this claim (of which no evidence is provided), it completely overlooks quasi-facilities based

⁴⁷ See for example, ACCC, *Final Determination for Model Price Terms and Conditions of the PSTN, ULLS and LCS services*, (October 2003); ACCC, *Pricing of Unconditioned Local Loop Services (ULLS): Final Report*, (March 2002); ACCC, *Final Decision on whether or not a Line Sharing Service should be declared under Part XIIC of the Trade Practices Act 1974*, (August 2002), ch. 7; ACCC, *Declaration inquiry for the ULLS, PSTN OTA and CLLS: Final Determination* (July 2006), ch. 7.

⁴⁸ See also ACCC, *A strategic review of the regulation of fixed network services: ACCC position paper* (June 2006), pp. 31-32 where the same passage can be found verbatim.

competition. This is particularly surprising given Optus' recent announcement that it will cease selling Telstra Local Access Resale and Resale DSL consumer products in all areas where its own network is operational from 25 June. Further, that it will transition customers not presently served by its network to its own services as they come online. In this regard, Optus states that it had equipped 204 exchanges at the end of 2006 and that engineering teams are on track to rollout an additional 236 exchanges by year-end.⁴⁹ A Morgan Stanley report released when Optus began its rollout in 2005 suggested that once the ULLS market is established, Telstra could lose up to 60% of its wholesale broadband customers, a scenario that would result in the loss of 22% of its data revenues, and 19% of PSTN revenues.⁵⁰

In addition, the availability of alternative infrastructure is an under-recognised reality. Telstra does not repeat what it has said elsewhere about this issue, it is sufficient for present purposes to refer to the discussion in Telstra's submission to the Australian Competition and Consumer Commission: *Response to the ACCC Proposal - "A strategic review of the regulation of fixed network services"* (February 2006) and Attachment A: Non-Telstra Infrastructure Maps, as at September 2005. Optus has recently noted that it has continued its ULLS network rollout which, together with the existing HFC network, will cover approximately 3.9 million Australian homes.⁵¹

Finally, Telstra fails to see the relevance of the submissions set out in paragraph 7.10 of the Optus Submission. First, the Competition Notice Optus refers to has not only been revoked by the Commission⁵², it was formally declared invalid and set aside by the Tribunal on 5 April 2007.⁵³ Further, Optus has the benefit of an interim determination for the Wholesale Line Rental service at rates consistent with the Commission's indicative prices. Telstra also does not understand why it is "notable" that Telstra has received the same reductions in MTAS rates considering that the Commission has applied the same MTAS rates (to the best of Telstra's knowledge) across all access disputes in relation to the MTAS to date. Once it is accepted that access prices should properly be based on cost, it is to be expected that the

⁴⁹ See *Optus to quit Telstra resale in on-net markets*, Communications Day, Issue 3008 (Monday 2 April 2007).

⁵⁰ *Ibid.*

⁵¹ SingTel / Optus, *Management Discussion and Analysis of Financial Condition, Results of Operations and Cash Flows for the First Quarter Ended 30 June 2006*, p. 34.

⁵² See the Commission's news release at entitled "Competition Notice lifted" dated 2 March 2007 at: <http://www.accc.gov.au/content/index.phtml/itemId/781832/fromItemId/2332>

⁵³ LeMay, *Federal court hands Telstra regulatory win*, ZDNet Australia, 5 April 2007. Available at: http://www.zdnet.com.au/news/communications/soa/Federal_court_hands_Telstra_regulatory_wi n/0,130061791,339274717,00.htm

same price should apply irrespective of the identity of the access seeker. This enables access seekers to compete on their merits in downstream markets.

Constraints on the pricing of fixed line telephony service

Aside from competitive constraints on Telstra's pricing conduct in respect of fixed line telephony services, Telstra is also subject to regulatory constraints. FTM calls are commonly provided and priced as part of a basket of fixed-line services including line rental, long distance, international, local and FTM calls.⁵⁴ The prices Telstra charges for these retail fixed-line telephony services are subject to price caps under the retail price control arrangements. Under both the present and immediate past retail price controls, FTM call prices have been regulated as part of basket of services including line rental, long distance, international, local and FTM calls.⁵⁵ Under the present retail price controls this basket of services is subject to a price cap of CPI - CPI - in effect imposing an overall price freeze in nominal terms on the services comprising the basket. Under the immediate past retail price controls, the price control basket was subject to a cap of CPI - 4.5% - in effect requiring the aggregate price of the services in the basket to decline by 4.5% annually in real terms.

The retail price control arrangements effectively control and limit any power over price Telstra might have in respect of the provision of fixed-line services. As Optus has stated:⁵⁶

"The market for fixed-to-mobile calls is very competitive, and the fixed-to-mobile call prices reflect this. According to the ACCC's Division 12 reports the price of fixed-to-mobile services have (sic) fallen substantially for at least the past three years. ...

Telstra's dominance over access to the local loop does not restrict pricing in this market.

...

Fixed-to-mobile calls are currently part of a call services basket...[that] also includes STD, IDD and local calls. Therefore, the ability of fixed operators to increase fixed-to-mobile call prices will be severely limited. ...

⁵⁴ ACCC Price Control Review (2005), pp. 23 and 43.

⁵⁵ The present price control is: *Telstra Carrier Charges – Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2005*. The immediate past price control is: *Telstra Carrier Charges - Price Control Arrangements, Notifications and Disallowance Determination No. 1 of 2002*. See also: ACCC Price Control Review (2005), p. 20; *Telstra Carrier Charges - Price Control Arrangements, Notifications and Disallowance Determination No. 1 of 2002: Regulation Impact Statement*.

⁵⁶ Optus MSR Submission, paras 2.33, 2.34, 5.37, 6.67 and 6.70.

In any event, as discussed below, it is apparent that the prices for services in the Price Control Basket (including FTM call prices) have been falling in real terms and at rates faster than those mandated by the retail price controls - itself a sign of the competitive forces at play in the market in which FTM services are provided.

The pre-select arrangements have also assisted a carrier's ability to effectively compete in respect of services in the Pre-Select Basket provided over the local loop. Again, industry participants and the Commission have recognised this effect.⁵⁷

Fixed to mobile substitution

Optus' submission also undervalues the significance of competition from substitute technologies. While the Optus Submission suggests that competition in retail mobile prices has been vigorous and suggests that evidence of fixed-to-mobile substitution is strong,⁵⁸ it fails to recognise the implications of these observations as confirming the constraints to which the price of FTM calls are subject and the effect that this has on Telstra's position in respect of the market in which fixed line services are provided.

With mobile subscription penetration reaching saturation, mobile services are increasingly becoming substitutable for fixed line services. As a result, mobile-to-mobile ("MTM") calls provide an effective substitute for FTM calls and a competitive restraint on the pricing of those calls. From an end-user's perspective, there is little to no difference between making a call to a mobile from a fixed-line or from a mobile phone - the decision will largely be a function of price and convenience.

This view is consistent with that previously espoused by industry analysts and other industry participants.⁵⁹ One industry analyst has observed that:⁶⁰ "empirical evidence suggests the Australian market is at the cusp of wholesale migration of voice traffic to mobile services." Vodafone has stated that it is "actively encouraging customers to substitute fixed calls with mobile calls with a number of customer offerings" and that it considers that the recognition

⁵⁷ See Vodafone, Submission to the Australian Competition and Consumer Commission: Mobile Services Review 2003 Discussion Paper, (13 June 2003) ("**Vodafone MSR DP Submission**"), paras 3.64 and 3.66; Optus MSR Submission, paras 2.35, 6.63 and 6.64; and ACCC, *Changes in the price paid for telecommunications services in Australia 1997-98 to 2003-04: Report to the Minister for Communications, Information Technology and the Arts*, (March 2005) ("**ACCC Pricing Report 2003-04**"), p. 23.

⁵⁸ See the Optus Submission at paras 7.17 to 7.30 and 7.36.

⁵⁹ See for example Optus MSR Submission, para 2.20. Optus also notes in that submission that "[f]ixed and mobile telephony are increasingly being bundled in the one service offering" (para 2.44).

⁶⁰ Report from Citigroup (11 October 2004) quoted in *ACCC Price Control Review* (2005), p. 20.

“that there is competition between [MTM] and [FTM] is in fact acknowledging that mobile services are part of a broader telephony market.”⁶¹ Vodafone has elsewhere acknowledged that.⁶²

“For some people, mobile phones have now become a real alternative to the fixed line. Over time, we believe that fixed to mobile substitution will continue, particularly for voice services.

...

[T]here are an increasing range of substitutes available for a fixed to mobile call (not least being the significant increase in mobile penetration - which allows people to use mobile to mobile calls as an alternative to fixed to mobile calls).”

A 2006 Vodafone media release reported.⁶³

“A Newspoll survey commissioned by Vodafone has revealed that approximately 1.4 million Australians see few reasons to hold onto their landline and are seriously considering ditching it altogether to become totally mobile inside the next two years.

The results expose that Australian mobile users are questioning the need to pay multiple phone bills and are switching to using their mobile at home:

- *Approximately 4 in 10 say their mobile is now their main point of contact*
- *22% would ditch their landline and just use a mobile if they moved houses*
- *40% have friends who’ve already ditched their landline, making them more likely to consider going totally mobile*

Based on the survey findings, the move to ditch the landline and switch to mobile at home is largely being driven by the availability and affordability of capped mobile plans.”

⁶¹ Vodafone letter to ACCC dated 9 October 2003, p. 6. Available at: <http://www.accc.gov.au/content/item.php?itemId=708261&nodeId=68fdbba249af08ca8429d820b88c2e02&fn=Vodafone3.pdf>

⁶² Vodafone MSR DP Submission, paras 3.22 and 3.65.

⁶³ Vodafone, *1.4 million Australians consider ditching their fixed line in next two years*, (media release) dated 22 February 2006.

In the same media release, Vodafone went on to report its view that there are a growing number of Australians replacing their landline and moving to Vodafone cap plans and that more customers are using their mobile for everyday calls at home. Further, that Vodafone expected this trend would continue such that more people will “use their mobile as their main point of contact” and would accelerate as mobile broadband using 3G networks became increasingly available.

In Australia, mobile penetration rates have grown from 42% in 1999-2000 to 98% at 30 June 2006 (as estimated in a recent report by SingTel / Optus).⁶⁴ The number of fixed line connections has begun to decline in developed countries. Australia has recorded a decline in fixed line subscriptions in recent years (having peaked at 10.4 million SIOs in 2002).⁶⁵ Moreover, there is now a higher penetration rate for mobile than for fixed line networks, at least for personal communications.⁶⁶

Fixed and mobile services provide many of the same basic functions (dial tone, phone number, long distance access) and their price levels and structures have converged over time. While early mobile telephony was not a particularly good substitute for fixed lines, factors such as the roll-out of digital technology in 2G and 3G networks, increased network coverage and higher quality transmission have improved the substitutability of mobiles. Moreover, with the advent of video calling, mobile telephony arguably provides superior call functionality to fixed lines. Mobile call prices have also substantially decreased.

In the Vodafone Undertaking Decision, the Commission recognised “that fixed-to-mobile substitution is starting to become a more common feature of the telecommunications sector more broadly”.⁶⁷ This is consistent with the view of the Commission’s expert consultant, WIK, who observed a gradually increasing trend to substitute fixed access lines by mobile subscriptions, with the number of telephone users giving up their fixed-line subscription and becoming mobile-only users being an increasing reality in Australia.⁶⁸ Irrespective of whether an end-user abandons their fixed line in favour of becoming a mobile only user, at the level of any individual calling decision a mobile call now represents a substitute to a fixed line call.

⁶⁴ SingTel / Optus, *Management Discussion and Analysis of Financial Condition, Results of Operations and Cash Flows for the First Quarter Ended 30 June 2006*, p. 37.

⁶⁵ WIK Report, p. 48.

⁶⁶ WIK Report, p. 48.

⁶⁷ ACCC, *Assessment of Vodafone’s mobile terminating access service (MTAS) Undertaking: Final Decision (public version)*, (March 2006) (“Vodafone Undertaking Decision”), p. 83. Cf. *ACCC Price Control Review* (2005), p. 19.

⁶⁸ WIK Report, p. 48.

The growing substitutability of fixed and mobile services points to the present and growing reality that the prices for fixed services (including FTM calls) are constrained by competition from the mobile sector. Evidence of this trend - with the result of declining PSTN revenues - has been noted in the financial reports of a number of carriers including Telstra.⁶⁹

Substitutes using alternative delivery means

The pricing of services that are substitutable for fixed services and/or use alternative delivery means also provides an effective constraint on the pricing of fixed line services. For example, as discussed above, mobile call prices constrain fixed call prices, as can VOIP technology.

As discussed in Telstra's *Submission to the Australian Competition and Consumer Commission: Response to the ACCC Proposal - "A strategic review of the regulation of fixed network services"* (February 2006), as at 30 September 2005, total broadband take-up totalled 2,593,600 subscribers, a 98% increase from the September 2004 figure of 1,311,100.⁷⁰ Approximately 60% of these customers were with a service provider other than Telstra. Moreover, this included 40,800 wireless broadband services in operation⁷¹ with additional broadband wireless networks in development or being rolled out in metropolitan, regional, rural and remote areas. At least 26 of the 40 new carrier licences issued in 2004-05 were to carriers proposing to deploy broadband wireless access technologies.⁷² The number of broadband subscribers is forecast to grow by 55% in 2006.⁷³ If this holds, it would see broadband taken up by 4 million subscribers, almost 50% of Australian households.

With increased broadband penetration, VOIP services are poised to become important substitutive technologies in the Australian market. There were 43 consumer VOIP

⁶⁹ See for example, Telstra, Appendix 4D: *Half Yearly Report for the half year ended 31 December 2005*, pp. 11-12; and SingTel / Optus, *Management Discussion and Analysis of Financial Condition, Results of Operations and Cash Flows for the First Quarter Ended 30 June 2006*, p. 40.

⁷⁰ ACCC, *Snapshot of broadband deployment*, (September 2005).

⁷¹ ACCC, *Snapshot of broadband deployment*, (September 2005).

⁷² ACMA, *Telecommunications Performance Report, 2004-2005*, p. 2.

⁷³ Citigroup Global Markets Equity Research, *More Pain before Gain in 2006*, (20 January 2006), p. 11.

providers as at June 2005 and 19 IP centric providers as at April 2005.⁷⁴ The experience in France is illustrative:⁷⁵

“Last year France Telecom predicted that the proportion of VoIP (voice over internet protocol) telephony would rise to about 15 per cent of residential traffic by the end of 2005. But it said yesterday [12/01/06] that take-up was accelerating and would reach 40 per cent by the end of this year.”

In a recent review of the retail price controls, a number of industry participants (including Telstra, Optus and Chime) made submissions recognising that VOIP was a key driver of widespread competition and that rapid growth in that technology would pose a significant challenge to fixed line services in coming years.⁷⁶ While the Commission did not consider at the time of making its report in February 2005 that VOIP posed a significant threat to traditional fixed-line services, it did note that an issue for future retail price controls would be “the effect of new technologies, such as Voice over Internet Protocol (VoIP), on pricing structures”.⁷⁷ Since that time the impact of VOIP has become an increasing and apparent reality. This view has been shared with various industry commentators, one of whom has observed:⁷⁸

“...The bigger threat [to revenues] in the long term, especially to Telstra, is VoIP over broadband. It has the ability to push down fixed-voice prices dramatically, as experienced in North America, where some customers enjoy rates more than 50 percent lower than those they had previously been paying...

...

The fixed-to-mobile substitution is only part of the story. In another three to four years, the pressure on the fixed-line voice market will intensify as VoIP over broadband services introduce new and potentially radically cheaper pricing into the market place. At that point, the decline in the fixed-voice revenues will speed-up sharply”.

⁷⁴ Telsyte Industry Profile, *VoIP - Consumer Information and Regulatory Participation*, (December 2005).

⁷⁵ Tom Braithwaite in Paris, FT.com site: *Popularity of broadband hits France Telecom*, (13 January 2006).

⁷⁶ See ACCC Pricing Report 2003-04, pp. 17 and 93.

⁷⁷ See ACCC Pricing Report 2003-04, pp. 1 and 93-100.

⁷⁸ VOIP News, *Aussie Telco's (sic) face 40% decline*, (19 July 2005). Available at: www.voipnews.com.au/content/view/195/107/

The competition from services using VOIP technology is likely to intensify as it is delivered by way of wireless broadband technology - in particular WIMAX. For example, Hutchison and Skype have announced a deal to enable Skype VoIP services on mobile smartphone handsets using the 3G network.⁷⁹

Conclusion

All of the factors discussed above point to a market subject to strong competitive forces which are only increasing with the rapid technological advances that are occurring in the telecommunications industry (including since the Commission released its MTAS Final Decision almost three years ago). To date, no serious attempt has been made by Optus to consider and analyse the competitive effect of these forces.

While Telstra submits that in the context of the present Undertaking, the Commission need not come to any firm view about the state of competition in the market in which FTM services are provided, the competitive forces discussed above clearly constrain the prices which can be charged for fixed-line services (including for FTM calls) contrary to Optus' submissions concerning Telstra's supposed dominance of the local loop.

7.4 Reliance on MTAS revenue

Further, Optus argues in paragraph 7.15 of the Optus Submission that it is more reliant on access revenues than Telstra. Telstra fails to see how this is relevant to the LTIE or any of the other statutory criteria under section 152AH of the TPA. Optus' only legitimate interest is in obtaining MTAS revenue based on cost plus a reasonable rate of return. In this regard Optus' interest is the same as Telstra's.

7.5 Pass-through of lower MTAS rates

At paragraph 7.16 of the Optus Submission, Optus claims that Telstra, as the dominant fixed-line network operator, "has not passed on the full benefits of MTAS price reduction enforced by the [Commission] since 2004". At the outset, Telstra notes that Optus' submission appears to be specifically targeting Telstra without considering the position of other operators who only operate fixed-line networks (such as AAPT, PowerTel and Primus etc). Any complete consideration of the promotion of competition objective would necessarily include such providers. Nevertheless, Telstra submits that a consideration of the

⁷⁹ See VOIP News, *Mobile VOIP phones soon*, (22 February 2006). Available at: www.voipnews.com.au/content/view/348/107/; and *Wireless Carrier Offers Wholesale VoIP*, (4 May 2006). Available at: www.voipnews.com.au/content/view/1038/107/

market characteristics and competitive forces discussed above, supports the view that pass-through of lower MTAS rates is likely to occur in one form or another. In any event, as discussed below, even if those submissions are not accepted and the market in which FTM services are provided is characterised as being monopolistic, it is still the case that a significant amount of an input cost change would be passed-through absent any compulsion to do so. Aside from the fact that Optus' claim is not supported by the available evidence, there is no requirement that pass-through be solely in the form of retail price reductions and there are many other ways in which pass-through can occur.

FTM pass-through was the subject of detailed consideration by the Commission in its Mobile Services Review (which was subsequently reconsidered by the Commission in assessing Vodafone's rejected MTAS undertaking). That consideration arose out of the submissions of various interested parties which expressed concern that any reduction in MTAS pricing resulting from the declaration of that service would not be passed through to end-users by way of reduced FTM pricing.⁸⁰ In considering these issues the Commission concluded that the incorporation of a pass-through mechanism in any form was inappropriate.⁸¹ Rather, the Commission stated its expectation that, as a result of the declaration of MTAS, pass-through in excess of 100% could result.⁸²

One of the Commission's reasons for making the decision to use TSLRIC+ pricing for mobile termination regulation was that it would promote competition for the supply of FTM services. The Commission stated that lower FTM prices will likely result from lower MTAS rates and greater competition for supply of FTM services.⁸³ Given this, it is reasonable to provide the opportunity for TSLRIC+ based MTAS pricing to take effect and competition to develop before considering the implementation of prescriptive retail regulation. In this regard, Telstra notes it has not yet had the opportunity to receive MTAS prices from Optus that more closely reflect the underlying cost of the service.

Telstra notes that the UK Commerce Commission ("UKCC") came to similar conclusions in its comprehensive review of MTAS regulation. The UKCC concluded that the benefits of

⁸⁰ MTAS Final Decision, pp. 104ff and 223-226.

⁸¹ MTAS Final Decision, p. 226.

⁸² MTAS Final Decision, p. 223.

⁸³ MTAS Final Decision, p. 223.

lower termination rates would be substantially, if not wholly, passed-through to end-users and that a pass-through obligation was unnecessary.⁸⁴

Optus has also commented on the likelihood of pass-through as follows:⁸⁵

“There are adequate market forces to ensure an efficient pass-through of negotiated termination rate reductions. For example, there are numerous carriers and providers competing for long distance and fixed to mobile services and the retail fixed to mobile rate is regulated in the retail price control arrangements (as recommended by the ACCC).

...

Optus observes that retail fixed-to-mobile prices have generally fallen in line with lower termination rates. ... [O]verall falls in termination rates appear to have been passed on to retail fixed-to-mobile customers.”

Optus has restated its position in a more recent submission to the Commission in respect of the Vodafone Undertaking where it presented further evidence indicating that FTM retail prices have fallen in line with, or faster than, reductions in MTAS rates from 1998-2004.⁸⁶ Optus also provides evidence indicating that no supernormal economic profits are being earned in the retail fixed telephony market - which it indicates is “workably competitive” - and points out that basic economic theory dictates that even if the market in which FTM services are provided is monopolistic, a profit maximising monopolist would still pass through a significant amount of an input cost change absent any compulsion to do so.⁸⁷ This last point was also recognised by the Commission in the MTAS Final Decision.⁸⁸

Notwithstanding Optus’ previous position, it now seeks to maintain that reductions in MTAS rates have not been passed-through. In support of this contention, it purports to provide a percentage comparison of reductions in FTM and MTAS rates.⁸⁹ Telstra submits this analysis is misleading. First, the report referenced by Optus specifies a FTM price

⁸⁴ UKCC, *Reports on references under Section 13 of the Telecommunications Act 1984 on the charges made by Vodafone, O2, Orange and T-Mobile for terminating calls from fixed to mobile networks*, (January 2003), pp. 94 and 108-109.

⁸⁵ Optus MSR Submission paras 7.35, 7.38, and see also paras 7.40-7.41.

⁸⁶ Optus, *Submission to the Australian Competition and Consumer Commission on Vodafone’s revised mobile terminating access service undertaking lodged 23 March 2005*, (August 2005), (“Optus - Vodafone Undertaking Submission”), pp. 7-12 and note in particular Figure 4 on p. 12.

⁸⁷ Optus - Vodafone Undertaking Submission, p. 7-11.

⁸⁸ MTAS Final Decision, p. 169.

⁸⁹ See the Optus Submission at para 7.12.

reduction of 2.2 per cent, not 202%, in 2003-04. Secondly, Optus has compared financial years (eg 2003-04 and 2004-05) for FTM rates to calendar years (eg 2005, 2006, 2007) for MTAS rates. Thirdly, it has compared the wrong time frame - ie from June 2003 to June 2005 for FTM prices compared to June 2004 to June 2007 for MTAS prices. Fourthly, a direct comparison of percentages distorts the actual reductions in prices without reference to the bases upon which those percentages have been calculated. Fifthly, the Current Pricing Principles were not made until June 2004 (which is the commencement of the 2004-05 financial year), and reductions in MTAS rates did not occur immediately and generally involved a time lag.

Contrary to Optus' contention, Telstra submits that empirical data suggests that to date, sufficient pass through has occurred. The Commission's report to the Minister titled *Telstra's compliance with price control arrangements: 2004-05* indicates that in that financial year Telstra passed its 2004-05 price cap requirements with several percentage points to spare. Furthermore, that Telstra exceeded requirements across the three price baskets by between 2.7% and 15.2%.

Importantly, the Commission's report indicates that, notwithstanding that Telstra could have increased the weighted-average price for the first basket by 5.9% without exceeding the price cap, the weighted-average price actually decreased by 3.3%. Accordingly, the Commission notes that Telstra could have charged a weighted-average price for the first basket that was 9.2% greater than it actually charged and met this price cap.

The Commission's report also indicates that the largest contribution to the decrease was made by trunk calls (which includes FTM calls). The report states (at p. 8):

"The largest contribution to the decrease in the price of the first basket for the financial year 2004-05 was made by trunk call services followed by local calls. The price of trunk calls decreased by 2.7 per cent, which after weighting, contributed a reduction of 1.7 percentage points in the price index for the overall first basket."

The more recent version of this report confirms that this trend is continuing:⁹⁰

"The determination provides that the revenue-weighted price movement of the first basket (containing local calls, trunk calls and international calls) must not exceed CPI -4.5 per cent. The specified CPI measure represents the aggregate price movement in the all-groups basket for the weighted average of the eight

⁹⁰ ACCC, *Telstra's compliance with price control arrangements: 1H 2005-06*, (August 2006), p. 6.

Australian capital cities, as published by the Australian Bureau of Statistics, for the financial year immediately preceding the price cap period, that is, 2004–05.

*In the 2004–05 financial year, the CPI increase was 2.4 per cent. As the current price cap period is for six months only, Telstra would have been required to reduce its overall revenue-weighted prices by 1.05 per cent [(2.4 per cent – 4.5 per cent)*0.5] in the first half of the 2005–06 financial year.*

...

...the weighed-average [sic] price has actually decreased by 4.5 per cent. Accordingly, Telstra could have charged a weighted-average price for the first basket that was 3.4 per cent greater than it actually charged and met this price cap.

...

The largest contribution to the decrease in the price of the first basket for the period, July–December 2005, was made by trunk call services...”

This is consistent with the findings in the Commission’s most recent *Telecommunications Market Indicator Report: 2004-05* (July 2006) which noted the declining revenues from FTM calls (at p. 5):

“Revenue from fixed-to-mobile call services fell from \$2.2 billion in 2003-04 to \$2.1 billion in 2004-05, a decrease of 2.8 per cent. This is the first decrease in fixed-to-mobile call revenue since the ACCC began compiling this report. In 2003-04 and 2002-03, revenues for this service increased by 5.8 and 7.2 per cent, respectively. In 2004-05, revenue from fixed-to-mobile services accounted for 24 per cent of total PSTN revenue compared to 21 per cent in 2001-02.”

That Telstra could have charged more for FTM services under the PCD but did not, that FTM call prices have steadily declined and revenue from FTM calls has decreased, all point to the fact that Telstra is not exercising power over price in respect of FTM calls and that the market in which FTM calls are provided is subject to ever increasing competitive pressures and constraints.

Further support for the extent of pass-through can be found in a submission prepared by Access Economics in relation to the WIK Model (“Access Economics Submission”).⁹¹ For the purpose of that submission, the CCC commissioned Access Economics to assess, inter alia, the merits of the Commission’s adjustment path from 21 cpm in 2004 to 12 cpm in 2007 as contained in the Current Pricing Principles and its effect on mobile network operators (“MNOs”). As part of that assessment, Access Economics considered the so-called “waterbed effect” propounded by Optus and the extent of pass-through of reduced MTAS rates to retail prices during the period in which the Current Pricing Principles have been in effect. Access Economics found that:⁹²

“...data from Telstra’s Half-Year and Annual Reports suggest that the reduction in the MTAS in each period has been met by a subsequent significant reduction in the average FTM rate it charges...”

In considering the extent of pass-through of reduced MTAS rates to FTM prices, Access Economics analysed Telstra’s average FTM prices and noted:⁹³

“...there was 75.53% pass through of the reduction of the MTAS from 21 cpm to 18 cpm in 2005, and a further 78.82% pass through of the reduction of the MTAS from 18 cpm to 15 cpm in 2006. This decrease is even more notable given that there has also been an annual rate of inflation between 2-3% over this period.”

Given that retail prices (and in particular FTM prices) have been falling in accordance with corresponding reductions in MTAS rates, Optus’ submissions on pass-through lack conviction.

In any event, Telstra submits that it is incorrect to consider the benefits of reduced MTAS rates solely by reference to reductions in FTM call prices. The state of competition - and the likelihood of pass-through - cannot be determined by a simple correlation between MTAS rates and FTM prices (although, as discussed below, evidence concerning these matters tends to confirm that the market in which FTM services is provided is subject to strong competitive pressures as FTM prices continue to fall below regulated levels). Any assessment of FTM competition should consider a range of indicia (including new and emerging sources of competition) and, importantly, must recognise that FTM services are

⁹¹ CCC, *Response to the ACCC MTAS Pricing Principles Determination 1 July 2007 to 30 June 2009*, (16 March 2007).

⁹² Access Economics Submission, p. 1.

⁹³ Access Economics Submission, p. 14.

supplied jointly with other PSTN services.⁹⁴ It also must be recognised that the benefits of reduced MTAS rates can be realised in a number of ways.

These considerations were recognised by the Commission in the MTAS Final Decision where it stated:⁹⁵

*“...even if pass-through is not complete, this does not mean competition will not be promoted in the market within which FTM services are provided. ... [A]ctual improvements in competition might emerge in a range of other ways...
...[I]mproved competition may alternatively manifest itself in the form of improved quality of service rather than 100 per cent pass-through of price reductions for FTM call services.”*

Providing access seekers with the flexibility to choose how to best pass-on the benefits of price reductions in MTAS to consumers is an important aspect of a firm’s ability to compete in a given market. In *Re Queensland Co-Operative Milling Association Limited* (1976) ATPR ¶40-012, the Tribunal recognised both flexible pricing and other aspects of competitive rivalry as being important aspects of competition (at 17-246):

“In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.”

In the present context, flexible pricing recognises that pass-through will occur most effectively across a basket of PSTN services. It is valuable to preserve flexibility for fixed-line carriers as to how that pass-through occurs, since this allows them to be guided by the differing demand elasticities - “reflecting the forces of demand and supply” - for different services, and allows them to pass-through reductions in a way that is of most benefit to end-users.⁹⁶ Furthermore, adequate recognition needs to be provided for competition

⁹⁴ As a consequence common costs will not necessarily be most efficiently recovered in the manner implied by a simple correlation between MTAS rates and FTM prices.

⁹⁵ MTAS Final Decision, pp. 123-124 and see also p. 223.

⁹⁶ The importance of allowing carriers flexibility in retail pricing has been accepted by both the Commission and the Minister in relation to the adoption of broad price-cap baskets in the retail price controls rather than isolated sub-caps for individual services: see ACCC, *Assessment of Vodafone’s mobile terminating access service (MTAS) Undertaking: Final Decision (public version)*, (March 2006), pp. 81-82; and ACCC Price Control Review (2005). This was accepted by the Minister in formulating the current PCD.

across “all dimensions of the price-product-service”. For example, pass-through may occur by way of improved quality of service.

7.6 Conclusion on promotion of competition

Optus has offered only unsupported and irrelevant assertions in support of its submission that a MTAS price of 12 cpm, as opposed to a lower price, would satisfy the promotion of competition criterion. These submissions are largely false on their merits and misplaced when properly considering the promotion of competition objective. Clearly it is efficient, cost-based pricing of the MTAS that best encourages competition. However, the available evidence all points to the conclusion that 12 cpm is likely to be significantly above the efficient costs of supply. On that basis, Telstra submits that it cannot be accepted that the price terms and conditions specified in the Undertaking will encourage the objective of the promotion of competition in relevant markets and hence that the Undertaking will promote the LTIE.

8 Any-to-any connectivity

The final consideration in relation to the LTIE criterion is the objective of achieving any-to-any connectivity. Telstra accepts that the Undertaking is consistent with this objective.

9 Other reasonableness criteria

Aside from the LTIE, the reasonableness test in section 152AH involve consideration of a number of other criteria. These other criteria are each discussed below.

9.1 Legitimate business interests of access providers

Having already established that a price of 12 cpm is likely to be significantly above the efficient costs of supply of the MTAS, this raises the question of whether this rate is nevertheless reasonable for the Undertaking period having regard to Optus’ legitimate business interests as an access provider of the service.

Optus submitted that a price of 12 cpm as specified by the Undertaking is consistent with its legitimate business interests. As recognised at paragraph 9.2 of the Optus Submission, the legitimate business interests of access providers criterion recognises that “investment in existing and new infrastructure will not be sustainable unless the ability of carriers and carriage service providers to recover the cost of providing services and to earn a commercial return on the investment in infrastructure is protected”.

However, it is submitted that Optus has not provided any evidence that its current investment plans and business planning will be adversely affected if the Undertaking is not accepted. Such information, were it to exist, would only be available to Optus (and clearly is not available to Telstra). That no such evidence has been presented is telling and suggests that Optus' submission lacks credibility.

Furthermore, Optus claims that its legitimate business interests "require that it is able to set a price that will allow it time to recover the lost termination revenue from other services including origination and subscription".⁹⁷ Hence, Optus submitted that it would be appropriate to apply the current MTAS rate of 12 cpm for an additional six months after the expiration of the Current Pricing Principles.

As pointed out above, the Commission acknowledged at the time it developed the Current Pricing Principles that a price of 12 cpm may be above efficient costs. Additionally, given the nature of the market, the Current Pricing Principles were not to apply for more than three years. Therefore, all mobile network operators have been on notice since the MTAS was declared in June 2004 that the price for supply of the MTAS may fall below 12 cpm once the Current Pricing Principles expire. Accordingly, there is simply no basis on which Optus can justify supplying the DGTAS at above cost for another six months after the expiration of the Current Pricing Principles. This is especially so in light of the availability of recent materials suggesting that the efficient costs of the MTAS are in fact much lower than 12 cpm.

In support of its arguments, Optus points to the alleged impact of previous MTAS price reductions on its business. Optus claims that this impact is "significant" and any further reductions below 12 cpm would have a "significant effect on Optus' net revenues and hence ability to adjust prices".⁹⁸ In this regard, Telstra makes the following submissions.

First, as discussed in section 7.1 above, Optus appears to have exaggerated the impact of reduced MTAS rates on its business. Optus has itself admitted in paragraph 7.4 of the Optus Submission that its operating revenues actually increased by 1.1% despite decreased MTAS rates. In addition, as Telstra pointed out in section 7.1 of this submission, the evidence suggests that reductions in MTAS rates are being virtually cancelled out by

⁹⁷ Optus Submission, para 9.10.

⁹⁸ Optus Submission, para 9.8.

increased call volumes. This is consistent with the trend noted in the Access Economics Submission which stated:⁹⁹

“...data from the Telecommunications Market Indicator Report 2004-05 illustrate that between the financial year of 2003-04 and 2004-05, there was a decline in the revenue per minute derived from retail mobile services by all MNOs. That is...the minutes of use increased at a greater rate than overall revenue derived from retail mobile services, and the average revenue per minute derived by Telstra, Optus, Vodafone, Primus and AAPT for 2004-05, declined by just over one-and-a-half cents.” (Footnotes omitted)

Secondly, the so-called “waterbed effect” has already been dismissed by both the Commission and the Tribunal. In the Optus Tribunal Decision, the Tribunal held, with reference to the Commission’s submissions in that context that (at [84]-[85]):

“Optus’ argument that its DGTAS was supplied in the retail mobile services market was made in support of its claim that any profits flowing to Optus from its DGTAS being priced above TSLRIC or FL-LRIC would be competed away in the retail mobile services market because that market is effectively competitive. This was described as the waterbed effect. The Commission challenged this line of reasoning. First, the Commission submitted that Optus’ analysis did not address the fixed-to-mobile services market which was not effectively competitive. Secondly, the Commission contended that the DGTAS was not supplied in the retail mobile services market. Thirdly, the Commission argued that there was no effective competition in the retail mobile services market. The Commission’s concern about DGTAS being priced above TSLRIC was more its effect on the fixed-to-mobile market than on the retail mobile services market.

...in determining the price it will charge its customers for making calls, Optus must factor into its calculations the price it will have to pay other network operators for having its customers connected into their networks so that its customers’ calls can be so connected and the calls terminated and the revenue it will receive from supplying its DGTAS to other network operators. Even if the retail mobile services market were effectively competitive we do not consider that Optus would be strongly constrained in setting its DGTAS price by competition in the retail market. The mobile operators could set their termination charges on a reciprocal basis at

⁹⁹ Access Economics Submission, p. 6.

above cost while still competing vigorously in the retail market. Indeed, it was accepted that that is what they do.” (Emphasis added)

Thirdly, available evidence confirms the absence of the waterbed effect in relation to MTAS prices and suggests that pass-through of reduced MTAS rates to retail prices has been sufficient (see section 7.6 above). In this regard, the Access Economics Submission also considered claims by operators (including Optus) that a waterbed effect would occur due to reductions in MTAS rates and found no evidence in support of that claim. Rather Access Economics found that:¹⁰⁰

“While theory suggests that a rebalancing of retail prices will occur when an additional constraint is introduced on a service in a competitive two-sided market, in practice there has been no empirical evidence amongst the MNOs to support this so-called ‘waterbed effect’. Instead of retail mobile prices increasing and handset or subscription subsidies being eliminated due to a fall in the MTAS rates, there has been a decrease in retail prices for mobile outbound calls and an increase in the level of handset subsidies accompanying the fall in the MTAS rates. (Emphasis added)

More specifically, Access Economics analysed the effect of reduced MTAS rates on Telstra’s and Optus’ average retail prices for mobile services and found that there was no evidence of a waterbed effect. In respect of Optus, it was found that:¹⁰¹

“Similarly, Optus’ financial data on post-paid subscribers from the September 2006 quarter and the December 2006 quarter do not reflect signs of a waterbed effect. They illustrate that:

- *the Optus’ post-paid subscriber ARPU has remained reasonably steady - ie \$75 for the September 2006 quarter and \$76 for the December 2006 quarter;*
- *there has been an increase in the level of MOU - ie 6% in September quarter and 2% in the December 2006 quarter; and*

¹⁰⁰ Access Economics Submission, p. 1.

¹⁰¹ Access Economics Submission, pp. 8-9.

- *revenue from data services as a proportion of the total service revenue has been increasing.*

These factors, along with Optus' acknowledgment in the September 2006 quarter that the MOU increase has mitigated ARPU and margin erosion for post-paid customers, implies there has been a decrease in the price/minute of mobile calls."
(Emphasis added, footnotes omitted)

Given the clear evidence that no waterbed effect has occurred or is likely, Optus' submission - made without any supporting evidence - that in setting the Undertaking price it "has had regard to the significant adjustment in subscription and origination prices needed to implement a price lower than that offered in the undertaking" cannot be sustained.¹⁰²

Rather, Telstra submits that since 12 cpm is already likely to be above the efficient costs of supply of the MTAS, there is no basis for artificially maintaining that price for another six months as suggested by Optus when there is evidence of sufficient pass-through and no evidence that a lower DGTAS rate will cause harmful disruption to the operations of mobile operators.

9.2 Interests of access seekers

Optus claims at paragraph 9.13 of the Optus Submission that 12 cpm for the Undertaking period promotes the interests of access seekers because "they are consistent with the rates that we expect would have been arrived at through commercial negotiations which are capped by the existing pricing principles that had 3 cent decrements in price on a calendar year basis".

This statement deflects attention from the critical matter at issue. Access seekers have a legitimate interest in acquiring the MTAS (and/or the DGTAS) at a price reflective of the efficient costs of supplying that service. Commercially negotiated rates, especially in circumstances where Optus is in a position to exercise power over the price of the DGTAS absent regulatory intervention, may or may not reflect the efficient costs of supply. However, it is pricing consistent with the efficient costs of supply that enables access seekers to compete on their merits in downstream markets. As discussed in detail above, the Commission cannot be satisfied on the available evidence that 12 cpm is reflective of the efficient costs of supplying the MTAS (and/or the DGTAS). To the contrary, the

¹⁰² Cf. the Optus Submission at para 9.8.

available evidence tends to indicate that a price of 12 cpm is well above the efficient costs of providing that service.

Moreover, Optus' statement is misleading. First of all, commercially negotiated MTAS prices are not, and were not expected to be, restricted by the Commission's Current Pricing Principles. Moreover, the Commission's previous approach of setting MTAS prices for a 12 month period based on the Current Pricing Principles had been predicated on the basis that those principles were in effect. This rationale clearly does not apply where the Current Pricing Principles have expired.

As submitted above, mobile carriers have been on notice since June 2004 that the price of the MTAS could fall below 12 cpm after the expiration of the Current Pricing Principles. This was confirmed by the release of the WIK Model in February 2006. It is therefore incorrect to assume that access seekers would have "expected" 12 cpm for another six months when all evidence points to the implementation of a lower price. It is in the interests of access seekers that MTAS prices be based on the efficient costs of supply. Optus has not offered any evidence which suggests that cost-based pricing of the DGTAS would impede the interests of access seekers, and accordingly, 12 cpm cannot be reasonable.

9.3 Direct costs

In the Optus Submission (at paragraph 9.15), Optus merely asserts that a price of 12 cpm is "consistent with the direct costs of providing the service, though these remain uncertain". Optus does not provide any explanation as to why this is the case. It is also surprising that Optus can claim that 12 cpm is consistent with the direct costs of supply, when it is itself uncertain of what that cost is.

Telstra submits that pricing on a TSLRIC+ basis would enable Optus to recover its direct costs of supplying the DGTAS. Telstra has demonstrated that the latest estimates of the TSLRIC+ price of the MTAS are substantially lower than 12 cpm. As discussed above, Optus' own cost model submitted in support of its Previous Undertaking strongly suggests that its direct costs are substantially below 12 cpm. Accordingly, Telstra submits that the price adopted in the Undertaking is likely to be significantly above Optus' direct costs of supplying the DGTAS. There is no basis for this pricing to be allowed to continue for another six months after the expiration of the Current Pricing Principles.

9.4 Operational and technical requirements

Telstra accepts that this criterion is not relevant to the Commission's assessment of the Undertaking or, in the alternative, that the Undertaking is consistent with this criterion.

9.5 Economic efficiency

Telstra submits that an MTAS price based on the efficient costs of supplying the service would satisfy this criterion. As discussed in detail in this submission, the Undertaking price of 12 cpm for the period 1 July 2007 to 31 December 2007 is likely to have substantially overstated the efficient costs of supply of the DGTAS. As such, the Undertaking is inconsistent with the economically efficient operation of a carriage service and a telecommunications network or facility. This also leads to the view that the Commission cannot conclude that the Undertaking price is reasonable.

In relation to this criterion, it is stated at paragraph 9.21 of the Optus Submission that Optus did not undertake a bottom up cost modelling exercise in devising its Undertaking price of 12 cpm given it believes that the mobile services market is competitive and the young age of infrastructure.

Telstra accepts that given the time and cost involved to construct a bottom-up cost model for the MTAS, the provision of such a model in support of the Undertaking is not necessary. Telstra also accepts that a properly specified top-down model would be acceptable for present purposes. Indeed, so much has been accepted by the Tribunal.¹⁰³ However, Optus does not address why it has not provided a top-down model in order to demonstrate the reasonableness of the price adopted in the Undertaking. Instead, Optus has purported to base its Undertaking price on sources which have been demonstrated to be weak and unsupportive. In the absence of a properly specified top-down cost model, Telstra submits that the Commission cannot be satisfied that the price adopted in the Undertaking is reasonable.

While Telstra considers that the competitiveness of the relevant market and the young age of the infrastructure can be important considerations, the Tribunal has previously ruled that these are not of assistance in determining the efficiency of Optus' and Vodafone's investment in their mobile networks. Both Optus and Vodafone made similar submissions to the Tribunal in support of the efficiency of the costs claimed in their previous MTAS

¹⁰³ Optus Tribunal Decision at [117].

undertaking. The Tribunal rejected these submissions in its decisions in respect of each of those undertakings.

In its decision in respect of the Previous Undertaking, the Tribunal stated:¹⁰⁴

Optus submitted that it was reasonable for the Tribunal to assume that the costs it incurred, when making its investment decisions, were incurred on an efficient basis. As its investment decisions had been made reasonably recently and in a highly competitive market, it was reasonable for the Tribunal to assume that its costs were incurred on an efficient basis.

...

However, there was no evidence before the Commission, or before us, that the cost inputs provided by Optus to CRA were efficient costs. Optus had identified costs relating to its GSM mobile business for 2003/2004 but there was no evidence before us that the costs so identified were "efficient". The Commission was also critical of the cost inputs used as they did not take into account economies of scale and the growth in economies of scale over time.

...

Although there is merit in the proposition that a firm in a competitive market has an incentive to be efficient and to incur its costs efficiently, there is still a need for the Commission (and, on review the Tribunal), to be satisfied, having regard to the matters set out in s 152AH and the objectives in s 152AB of the Act, that the firm's costs are efficiently incurred.

More specifically, in its decision in respect of Vodafone's MTAS undertaking, the Tribunal stated:¹⁰⁵

"We do not accept the proposition that Vodafone's actual costs can be taken to be efficiently incurred simply because Vodafone operates in a competitive market. While that market certainly exhibits some evidence of vigorous competitive processes, for example, in the marketing of various pricing plans, it does not follow that no scope exists for inefficiency. The very nature of mobile termination, where calls to each operator's customers can only be completed by that operator, argues

¹⁰⁴ Optus Tribunal Decision at [113], [114] and [118].

¹⁰⁵ Vodafone Tribunal Decision at [56]-[57].

for caution in concluding that inefficiency is absent. Furthermore, taken to its logical conclusion, the proposition would also lead to the view that Vodafone's actual VMTAS prices must be reasonable and thus warrant no regulatory examination.

More specifically, with only three operators in the market during the period of Vodafone's initial investment and roll-out of infrastructure, economic theory does not support the contention that those firms will, ipso facto, have made efficient investments. Services provided in the market are far from homogeneous, and the operators appear to have made great efforts to differentiate their services, build strong brand names, and appeal to varying groups of consumers.

On the basis that the Tribunal has already rejected Optus' submission, it must fail here and Optus' failure to provide any cost model in support of its Undertaking simply points to the fact that the Commission cannot be satisfied on the available material that the Undertaking is reasonable.

Telstra Corporation Limited

5 April 2007