5 November 2018

ACCAN thanks the Department of Communications and the Arts for the opportunity to contribute to its consultation concerning the proposal to change the designated day. Although ACCAN appreciates that there is a need to amend the Designated Day in order to bring it into alignment with the completion of the NBN, we do not support the continuation or extension of the exemptions in place for private wholesale networks.

We believe that a best practice approach should be applied to the assessment of the merits of extending the exemptions for networks, in accordance with domestic and international guidance. (OECD 2012; DPMC 2014). This approach entails answering several targeted questions.

What is the problem?

The first step in any policy assessment is to identify what the problem is that the regulation is targeted to address. The problem in this instance is that in the absence of regulatory intervention, infrastructure owners as monopolists will have both the market power and incentive to maximise their profits by charging prices in excess of competitive market rates and reduce costs by providing sub-standard services to consumers. This problem is well documented, and provides the rationale for regulatory intervention.

Market power continues to be a significant problem in the telecommunications sector, which is highly concentrated and has been identified as attaining rates of return in excess of competitive market rates of return on infrastructure networks (Grattan Institute 2017, p. 31). ACCAN considers that there is a continued role for government regulation to protect consumers from the abuse of market power by infrastructure owners and retailers, who may lack adequate incentives to act competitively.

What is the objective of the regulatory framework?

The purpose of the structural separation of wholesale and retail networks is to preclude the exercise of market power by owners of infrastructure in the wholesale market to the detriment of retail competition. By promoting efficient outcomes in wholesale service markets, competition is promoted in the retail context, allowing greater choice, better quality services and affordable services to be accessed by consumers.

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At an abstract level the objective of the regulatory framework is to promote competition and the efficient allocation of resources (that is the allocation of resources to their best and highest value use). In order to do so, firms must have incentives (through competition) to operate efficiently (that is, produce at the lowest technical cost) and offer services at prices reflective of the underlying cost. For consumers this provides material benefits by allowing them to access competitively priced services that reflect their needs that are priced to reflect the real cost of service provision.

What is the purpose of the exemptions?

The current framework of regulatory exemptions under the legislation does not have a clearly articulated objective, nor does it articulate a problem that the exemptions are specifically intended to address. These is inconsistent with best practice regulation (DPMC 2014; OECD 2012) which demands that regulation be problem focused, targeted, proportionate and provide net benefits (Kaldor 1939;_Hicks_1939).

The creation of a scheme of exemptions may only be justified on the basis that it is necessary to protect the sunk investments made by private investors. Where private parties have made investments in private infrastructure, it can be economically efficient to protect the rates of return of these investments where:

- they were undertaken in good faith on the basis of existing law and policy; and
- doing so ensures efficient future investment or 'dynamic' efficiency.

If investments were made under the above conditions, consideration should be given to how best to regulate the investments to both balance the contemporary needs of consumers and ensure adequate incentives for future investment to ensure ongoing access to affordable services. With respect to the current exemptions, it is not clear that either of these criteria is met.

At the time of construction of the Telstra South Brisbane and TransACT networks,[1] the Australian Government had articulated a clear policy position that future investments in wholesale telecommunications infrastructure would be undertaken publicly via NBN Co. Accordingly from 2007 onwards, private investors should have been cognisant that any investments made in constructing private networks was both contrary to government policy, potentially subject to regulatory intervention and/or direct acquisition.

Rather, the investments made at the time appear to have sought to foreclose subsequent investment, and frustrate the stated policy objectives of the government. The foreclosure of infrastructure investment (Hart et al. 1990; Rey & Tirole 2007) is a well-documented strategy to preclude competition emerging within markets by controlling supply in wholesale markets in order to frustrate retail competition. The acceptance of the legitimacy of the investments made during this period through granting exemptions, and delays in either acquiring or overbuilding the infrastructure, has in effect rewarded monopolistic conduct.

[1]. In the TransACT context construction is used to refer to the significant upgrades program from copper ADSL to fibre.

The construction of private network infrastructure in that context entailed material commercial risks that investors implicitly accepted when undertaking their programs of investment.[2] Accordingly, protection of super-normal rents from these investments is neither necessary to ensure incentives for future investment nor appropriate given the material detriment that these exceptions are causing to consumers.

Since 2007, the policy position of government has been that investment in wholesale telecommunications infrastructure is to be undertaken by NBN Co. In this public monopoly context, the incentives for private parties to invest in wholesale telecommunications infrastructure have become irrelevant as, in accordance with public policy, private entities should not be constructing or investing in such infrastructure. The protection of any asset base accrued as a result may indeed affect private incentives for investment – but such incentives are no longer of any policy relevance, noting that private investment in wholesale broadband infrastructure should not be occurring.

What has been the market outcome?

In the absence of strong competitive pressure placed on network operators, the market outcomes have been markedly sub-optimal and characterised by higher than average retail prices when benchmarked against the nbn or alternative private networks, and sub-par service outcomes. The level of competition within exempt geographic markets remains weak.[3] Although the declaration of services by the ACCC has resulted in the imposition of some price controls on access and bandwidth pricing, these prices have been set at levels well in excess of those present in more competitive wholesale markets.

Regulatory measures have been taken by the ACCC (2017) through its final access declaration of superfast broadband access services to cap the maximum price of wholesale services, however retail price outcomes continue to be in excess of those available in competitive markets. Although the pricing regulation in place precludes the most egregious or excessive exercise of monopoly power by the wholesaler, it does not in fact put in place adequate incentives for efficient or competitive pricing of wholesale or retail services.

For consumers accessing services from networks subject to exemptions, the price and quality of services is inferior to those available on the open retail market via the nbn. The mark up present on service offerings is considerably higher than that elsewhere, and is consistent with both the existence and exercise of market power.

In the circumstances ACCAN considers that the Telstra mark-up is $15 to $20 above the normal competitive market price available to consumers elsewhere. An additional $15 or $20 margin per month implies that consumers are facing a $180 or $240 additional price premium over the course of a year.[4] These figures represent the minimum loss that consumers face, and work undertaken by ACCAN in 2015 and 2018 indicates that consumers have over a period faced prices in excess of 80% higher than those available on the nbn.

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[2]. This is to say that a conscious decision was made that it was commercially viable to construct a network liable to be compulsory acquired by the Australian Government.

[3]. This has been noted in the explanatory memorandum of the *Telecommunications (Network Exemption – Telstra South Brisbane Network) Instrument 2012* (Amendment No. 1 of 2018).

[4]. https://www.telstra.com.au/broadband/plans-bundles provides current prices for Velocity cable, which have been benchmarked against standing market offers on the nbn.

The offers available to consumers using different retailers on the network are similarly poor. These either have the similar mark-ups on the order of $15-$20 (Exetel), or had materially higher prices for considerably lower data and speeds (Internode).[5] In the case of Internode, information provided on their website indicates that the price of a 30/1 mbps service with a data allocation of 100GB was $99.90 per month, $45 more than the equivalent offering on a 25/5 mbps nbn plan (which has a price of $55 per month).[6] This reflects a mark-up of over 80% and is consistent with ACCAN's earlier benchmarking of prices provided to the Department. On the basis of information available on the Internode website it appears that Internode will no longer continue to sell new services within the Velocity network footprint. However, ACCAN is concerned that consumers locked into contracts with Internode are paying monopoly prices and are facing material loss.

In addition to poor market offers being made available to consumers, information concerning the availability of services is limited, resulting in significant information asymmetries (Akerlof 1970) and precluding effective competition (Beales, Craswell & Salop 1981).

For those consumers living within the geographic monopoly areas who have been subjected to margins (at a minimum) of this order magnitude for the previous five years, this implies a more than $900 to $1200 additional tariff, merely due to the absence of adequate regulatory measures. The extension of exemptions would also imply that for this cohort of consumers this loss is to be perpetuated for another 18 months, at a personal cost of $270 to $360 per consumer.

Costs to vulnerable consumers – the South Brisbane case study

Census data indicates that there are 11,207 private dwellings within the footprint of the Velocity network (ABS 2018a), which implies that the minimum loss for all households has been on the order of between $13.45 million to $10.08 million over the past 5 years.[7]

The impacts of monopoly pricing are disproportionately felt by those consumers on the lowest incomes, and with the least capacity to avoid costs. ACCAN has concerns that for vulnerable consumers those areas where exemptions have been granted that communications services have been set at prices well in excess of their capacity or willingness to pay, and that as a consequence these consumers have lost access to essential services.

Consumers on low incomes typically spend a significant proportion of their income on telecommunications services. Households in the first and second lowest income deciles on average pay just under 10% and 6% of their disposable income on communication services respectively (BCAR 2017, p. 27). This is well in excess of average household expenditure on communications, which accounts for approximately 3.5% of disposable income (BCAR 2017, p. 27).

These households are characterized by high levels of financial stress, which continues to be experienced by consumers on low incomes, with 15.6% of consumers in the lowest income quintile indicating they had been unable to pay their utility bills on time in the twelve months leading up to the census (ABS 2017).

[5]. https://www.internode.on.net/support/historical_product_info/end_of_sale/south_brisbane_fibre/

[6]. https://www.aussiebroadband.com.au/nbn-plans/

[7]. The banding of the estimates is due to the use of mark-ups of $15 to $20 per month to provide a range which is more robust than point estimates.

The Velocity network in South Brisbane currently covers approximately three SA2 statistical areas including West End, South Brisbane and Highgate Hill. An examination of Department of Social Services Statistics (DSS 2018) overlaid into the network area indicates that there are significant numbers of financially vulnerable consumers residing within the footprint of the network. There are currently:

- 1065 Age Pension recipients;
- 621 Disability Support Pension recipients;
- 746 FTB A recipients;
- 241 Carer's Allowance recipients;
- 761 Youth Allowance recipients;
- 1933 Commonwealth Rent Assistance income units.

For those individuals residing within the area on the Disability Support Pension (DSP), the loss associated with excess pricing over the preceding five years is estimated to be $745,200 for a $20 per month mark up, or $558, 900 taking a more conservative estimate of a $15 per month mark up.

Similarly for individuals residing in the area on the Age Pension, the cost of exemptions has been high. Noting that 55.3% of people over 65 use the internet (ABS 2018b) the affected population would at a minimum constitute 589 individuals. The estimated cost over the preceding five years would be $706,800 for a $20 per month mark up, or $530,100 taking a more conservative estimate of a $15 per month mark up. These estimates are likely to be overly conservative noting that for more than half of the population on the age pension within this area that the price of traditional phone services is also likely to have been subjected to mark up.

The proposed extension of the exemption time frame would have the effect of locking these consumers into further and unnecessary losses. For those on the DSP the losses over the next 18 months are likely to be $167,670 and $223,560 as a group. Similarly individuals on the age pension using the internet face losses on the order of $159,030 to $212,040 over the 18 month period.

For those consumers on limited incomes, the additional burden of monopoly or non-competitive prices is both inequitable and unnecessary. ACCAN notes that many of the consumers that rely on social security payments as their predominate source of income face a higher incidence of poverty than other consumers (Davidson et al. 2018). Individuals on Youth Allowance, Newstart Allowance and the DSP in particular face elevated risks of failing into poverty relative to the general population.

Average consumers residing in areas where they lack access to competitively priced services face unnecessary and ongoing detriment when seeking to access essential communications services. ACCAN considers that, in the absence of a clear policy objective supporting the continuation of exemptions, the exemptions should be allowed to lapse at their current date or even be revoked at an earlier stage. In any event, the expiry date should not continue to be linked to the Designated Day, as it is possible that the Designated Day will require further extension beyond 30 June 2020

Beyond Brisbane – the broader exemptions

The remaining 118 exempted Telstra Velocity network areas under section 141A (1) of the *Telecommunications Act 1997* (Cth) are geographically dispersed across the country and as a consequence performing a similar analysis of the losses accruing to consumers is comparatively more difficult. ACCAN has undertaken an initial examination of the population characteristics within those areas where an exemption has been granted and has concerns that there a significant number of vulnerable consumers living within the footprint of the exempt networks.

For example many of the 118 remaining Velocity networks cover areas where there is significant density of vulnerable consumers (e.g. retirement villages) and low income families (e.g. greenfield developments in Western Sydney).For low income families seeking to move to more affordable areas at the metropolitan fringe the continuation of exemptions merely increases the financial pressure that they face.

Although the geographic scale of the exempt networks in some instances is relatively constrained, detailed Department of Social Services data is available at the postcode level (DSS 2018) and although complex, site-by-site estimates of loss can be produced. However, ACCAN is in the process of producing estimates and would note that early analysis has identified that vulnerable populations (e.g. age pensioners and low income families) are concentrated in many of the 'greenfield' sites covered by the existing exemptions. We can provide further estimates of the loss for specific sites if required.

The TransACT network exemptions have similarly led to consumers facing higher prices than would arise in a competitive market. Consumers at the entry level for the TransACT network face entry level prices on the order of $70 for the equivalent of a 25/5 mbps nbn service.[8] For consumers accessing services via the nbn, an equivalent service may be purchased for $58, with some offers in the market currently allowing consumers to access considerably faster services (50/20 mbps) for $60. This implies loss for individuals on the TransACT network of a minimum of $120 per annum, noting that entry level offers at considerably low price points exist currently on the nbn. For a consumer seeking basic internet services the gap between TransACT pricing and nbn open access services is $20 per month or $240 per annum. As noted above, for those on low incomes this reflects a significant mark-up and implies material loss to these vulnerable consumers.

ACCAN considers that the sub-optimal market outcomes reflect the entrenched market power of integrated service providers, and that it is inappropriate in the circumstances to continue to provide exemptions, in the absence of any clear rationale for doing so. *What are the options?*

There are several options going forward:

- Allow the exemptions to lapse based on the current date;
- Extend the exemption to match the designated day;
- Revoke the exemptions prior to either date.

[8]. https://www.iinet.net.au/internet-products/broadband/vdsl2/ providing TransACT prices.

ACCAN considers that in the context of material detriment to consumers on exempt networks and no evidence of a policy rationale for extension, or a public benefit from extension, that the exemptions be revoked or lapse at the date currently specified.

ACCAN believes that the adoption of a clear and finite end-date for the negotiation of acquisition of exempt networks (or alternatively overbuilding) is necessary in order provide incentives for NBN Co. and Telstra to negotiate effectively. The ongoing extension of the exemptions indicates to both parties that there is no pressing need to resolve the question of these networks and is likely to extend the negotiation process, resulting in unnecessary additional transaction costs (Coase 1937), and the continuation of Telstra's monopoly power. The revocation of the exemptions or allowing their lapse at the existing date is likely to promote the resolution of the current impasse concerning acquisition or overbuilding.

Would the extension of exemptions pass a cost-benefit test?

The application of best practice regulatory approaches would preclude the continuation of the current exemptions on the basis that there is no adequately defined problem that they are targeted to address. In the absence of a genuine problem and clear objective, the framework of exemptions would fail to pass first principles regulatory assessment and therefore be abolished.

The losses to consumers in the South Brisbane network alone are of a material nature and over the next 18 months will total between $3 million to $4 million. The proposal to extend the exemptions for a period of 6 months will cost households within the area $1.34 million and provide no offsetting public benefit.

An assessment of the factual economic basis for the exemptions does not support their continuation, noting the material costs to consumers arising from their continuation and the absence of any clear economic benefit from their continuation. ACCAN believes that as a consequence of the exemptions failing to pass a net benefit test that they should be discontinued at the earliest possible opportunity, irrespective of changes in the designated day.

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