

G9 Submission to the Expert Panel for the National Broadband Network

28 March 2008



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1. Introduction

- 1.1 This submission to the Expert Panel is made by the G9, which is a consortium of Australian telecommunications companies including AAPT, iiNet, Internode, Macquarie Telecom, Optus, Primus, Soul and TransAct.
- 1.2 The G9 has consistently emphasised that the construction of a national high speed broadband network will have a permanent and significant long term impact on the telecommunications industry in Australia. Therefore, it is highly appropriate that an Expert Panel should be formed, to consider and recommend the policy framework, assessment criteria and process that will underpin the deployment of this infrastructure.
- 1.3 G9 members intend to participate in this tender process. Accordingly, the G9 has a specific interest in the assessment process and the criteria pursuant to which the Government will assess proposals for the construction of a high speed broadband network. The G9 has already undertaken considerable work analysing various models for the construction of a high speed broadband network and it has been the only consortium willing to subject large parts of its proposal to public scrutiny and industry comment. The G9 has formed a special purpose vehicle, FANOC Pty Limited (**FANOC**) which lodged a Special Access Undertaking (SAU) with the Australian Competition and Consumer Commission (**ACCC**) on 30 May 2007, which set out the proposed terms on which FANOC would provide wholesale broadband services over a high speed fibre to the node network. Following the release of the ACCC's draft decision on the SAU (which was in the main supportive of the terms proposed by the G9 in the SAU), the G9 intends to lodge a new SAU which preserves the main thrust of the SAU but responds to the constructive suggestions for improvement made by the ACCC.
- 1.4 The G9 members also have an interest in ensuring that, if any high speed broadband network is constructed in Australia, whether by the G9 consortium, Telstra or any other party, that network must be constructed and regulated in a manner that will promote competition and be in the long term interests of end users.
- 1.5 The G9 welcomes the establishment of the Expert Panel and the opportunity to comment on the proposed terms of the Request for Proposals (RFP).
- 1.6 This submission is set out in the following sections;
- (a) Section 3 discusses the need for regulatory reform and how the RFP can assist in achieving this;
 - (b) Section 4 discusses certain process requirements which should be addressed in the RFP in order to maximise competitive tension in the bidding process; and
 - (c) Section 5 discusses certain process issues related to the broader selection process for the National Broadband Network ("NBN").

2. Executive summary

- 2.1 In its policy document “A Broadband Future for Australia – Building a national Broadband Network” the then Labor Opposition identified the roll-out of a national high-speed broadband network as a fundamental requirement to Australia’s future productivity, competitiveness and wealth creation. The Rudd Government has now, quite correctly, set the delivery of this network as one of its key policy goals of its first term in office.
- 2.2 However, delivering the network is only one part of the equation. Australia will capture very little benefit from this significant new piece of infrastructure unless it delivers innovative services at the lowest possible prices to the broadest possible base of consumers. This will only occur if the network is open to effective competition.
- 2.3 In this context the key challenge for Government is to set the correct regulatory framework for access to the NBN, since this will be fundamental to determining whether the NBN delivers the benefits which the Government anticipates. The current regulatory framework, which was put in place in 1997, is simply not fit for purpose since it provides Telstra as the vertically integrated network owner with far too much incentive and scope to stifle competition. The G9 submits that the only appropriate policy response to protect and promote competition on the NBN, regardless of who builds the network is to ensure that there is structural separation between the entity which owns the NBN and any entity which delivers retail services over the NBN. The RFP provides the Government with a clear opportunity to ensure that proposals are tailored to an appropriate regulatory framework that will help maximise delivery against the Government’s key objectives.
- 2.4 The G9 intends to put a compelling proposal to the Government which will place competition and consumers interests at the heart of the NBN by ensuring that there is effective separation of interests between ownership of the network and downstream retail activities. This will address the many competition issues that have arisen from a vertically integrated access model and which have blighted the industry over the past decade.
- 2.5 Getting the regulatory settings right, including through mandating the structural separation of Telstra, is critical. A separate and equally important issue is maximising the competitive tension in the process of selecting the party to join with Government to build and own the NBN. To achieve this, the RFP should:
- (a) Specify clear assessment criteria;
 - (b) Require proposals to be broken out into geographic modules to ensure that there is full cost transparency and to maximise price tension in the bidding process;
 - (c) Provide a two-stage selection process with adequate time for bids to be prepared and the Panel and Government to consider those bids;
 - (d) Allow for a degree of flexibility in technology choices to deliver the Government’s minimum speed requirement; and
 - (e) Provide equitable access to information to all bidders.

- 2.6 To ensure that the Expert Panel and Government can make a fully informed assessment of the proposals, the RFP should require all proposals to clearly specify;
- (a) The proposed price and non-price terms and conditions of access;
 - (b) The proposed transition arrangements to apply to all existing customers (both retail and wholesale);
 - (c) How the proponent will deal with the need to compensate owners of existing infrastructure which may be stranded in connection with the implementation of the NBN; and
 - (d) Any proposed legislative changes required in connection with the proposal and how these are consistent with the long-term interests of end-users.

3. Achieving regulatory Reform is a critical requirement

- 3.1 The competitive selection process involves two quite separate processes for Government;
- (a) Selection of a successful bidder to construct the NBN; and
 - (b) Developing the regulatory framework that will facilitate competition on the NBN and deliver the desired consumer benefits.
- 3.2 These processes need not be mutually exclusive, in the sense that the development of the regulatory changes can and should proceed independently of the identity of the successful bidder. If Government is able to set the correct regulatory framework for the NBN such that it maximises competition and consumer welfare, then access seekers and consumers are likely to be indifferent as to who builds the network. This fact was acknowledged as recently as 15 March by Graeme Samuel in an interview with Communications Day:
- “I don’t think that actual ownership of the network ...is all that relevant to what we will ultimately be dealing with which is the regulatory environment that will impact upon the broadband network as it’s rolled out”.*
- 3.3 In developing the regulatory framework to apply to the NBN, Government needs to take account of;
- (a) The historic problems arising from Telstra’s vertical integration;
 - (b) The relative vigour of competition under resale and unbundling
 - (c) The economics and architecture of the proposed fibre to the node network; and
 - (d) The importance of competition in driving broadband uptake.

The problem of a vertically integrated incumbent

- 3.4 There is substantial economic literature on the problems associated with vertically integrated incumbents which control access to essential facilities. However, this is not simply a theoretical issue for telecommunications in Australia. The past decade provides far too many examples of Telstra using its position as the vertically integrated dominant supplier to undermine competition in the provision of fixed line services. The existing regulatory system has not been effective to prevent these attacks on competition. This problem has been particularly acute where competitors have relied on access to Telstra's resale based wholesale access services to compete in downstream markets.
- 3.5 The following table provides three real and practical examples of the problems faced by access seekers competing against Telstra.

Table 1

Because Telstra is **vertically integrated**, it can undermine retail competition in a way that the current regulatory system cannot control effectively

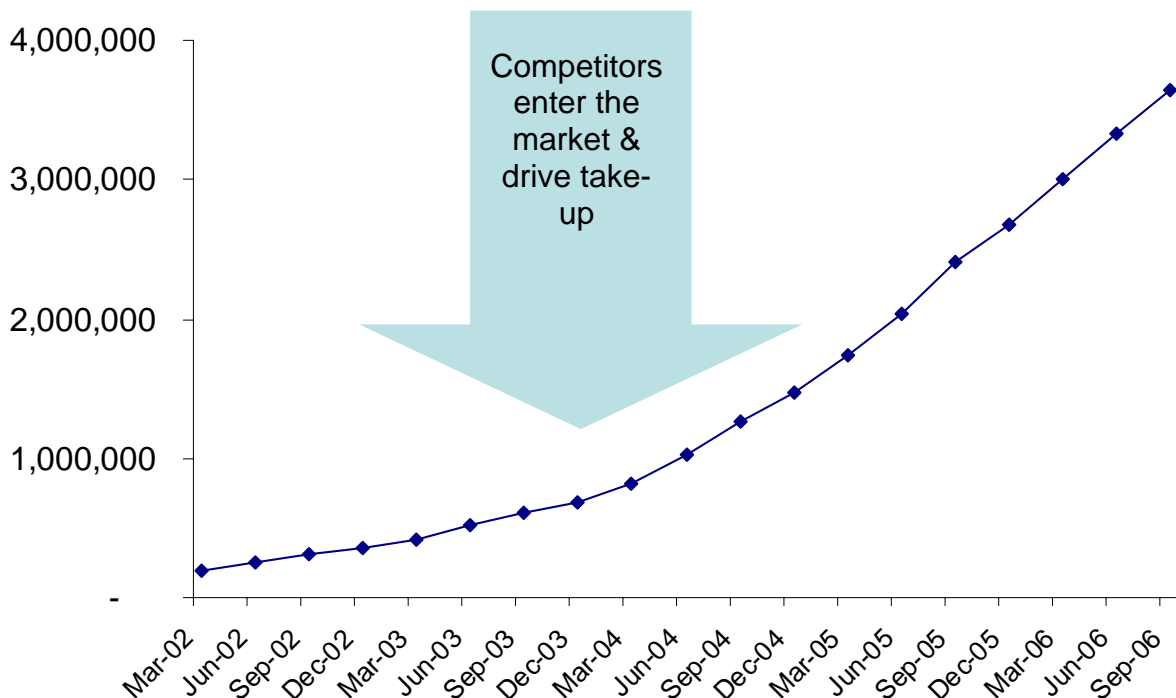
- Telstra can **refuse to sell** services to its retail competitors. For example, Telstra refused to provide access to its **Business Grade DSL service** to G9 members for well over a year, giving it the opportunity to lock-away the most valuable customers in the important early phase of this service.
- Telstra can provide **higher performance standards** to its retail customers than wholesale customers – for example, it routinely offers better connection times to its retail customers than it will provide to wholesale customers.
- Telstra can impose a **retail-wholesale price squeeze** – for example; when Optus entered the residential DSL market in 2004, Telstra reduced its entry level package price from \$59.95/month to \$29.95, well below the price it charged wholesale customers; and in December 2005 Telstra increased wholesale line rental prices by \$3.10 while not changing its retail line rental prices.

- 3.6 The slow emergence of broadband services in Australia can largely be attributed to Telstra's ability to use its position to undermine competition. It was in Telstra's interest to slow-down the pace of broadband take-up since it threatened to cannibalise its existing lucrative revenue stream from dial-up and voice access services. Telstra reaped the benefits of the status quo which saw many customers renting a second line from Telstra for their internet service. The development of broadband threatened this cosy position since customers migrating to broadband were likely to cancel their second line since voice and internet connectivity could be provided simultaneously. Indeed, merging broadband technology such as VOIP further threatens the high margin historical revenues underpinning Telstra's profits.
- 3.7 Telstra has specifically used its vertical integration to chill competition in broadband services with the result that take-up has been delayed. The way it has done this is to;

- (a) Initially set high prices for broadband access. Telstra only dropped its retail prices for broadband services when Optus commenced re-selling its wholesale DSL service in February 2004;
- (b) Squeeze the margin available to competitors taking its wholesale DSL service (see table above);
- (c) To limit the functionality of its wholesale broadband services and thereby hinder innovation by competitors, such as symmetrical services; and
- (d) To treat its customers contemptuously by artificially capping broadband speeds at 1.5Mbps on first generation ADSL (a technology capable of up to 8 Mbps) and delaying until February 2008 the introduction of ADSL2+ services (except in exchanges where it faced direct competition from ADSL2+ services provided by competitors using ULLS access to deploy their own equipment).

3.8 Notwithstanding Telstra's behaviour, competition has emerged and this has helped to drive broadband take-up from its delayed and sluggish start. The table below shows how competition has helped to drive take-up of broadband services.

Australian Broadband Take Up - ACCC Figures



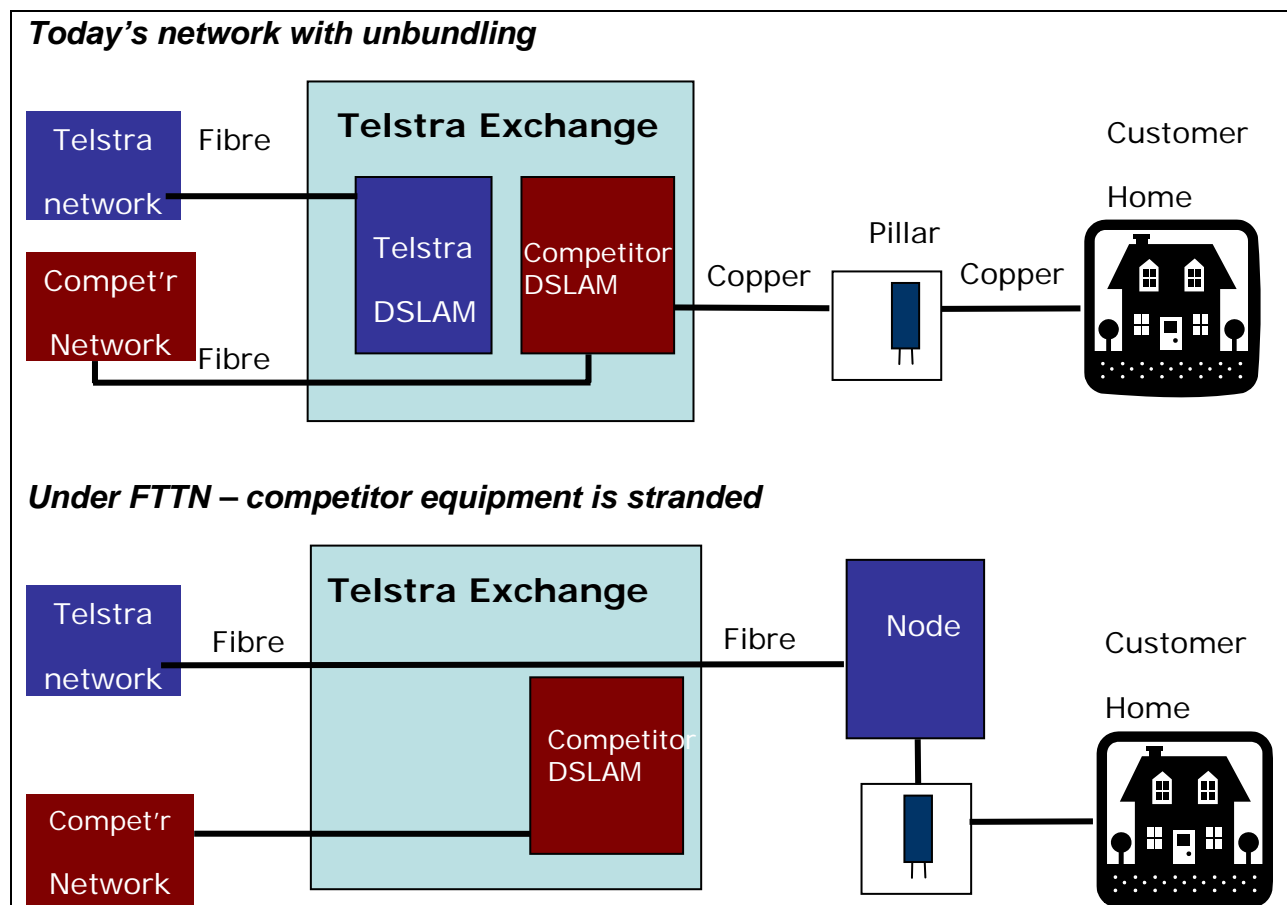
3.9 One of the few positive regulatory developments in fixed line competition has been the requirement for Telstra to unbundle its network. Competitors like Optus, Primus, Internode and iiNet are leasing Telstra's last mile copper loop

(the ULLS or LSS service) and combining it with their own electronics in the exchange to provide direct facilities based competition to Telstra.

- 3.10 At the current time there are some 1084 competitor DSLAMs deployed across metropolitan Australia¹ in some 387 exchanges. These are being used by Telstra's competitors to serve almost 800,000 customers... This development has driven important benefits to consumers in terms of price benefits and service innovation that would not be available had access seekers had to rely solely on Telstra's wholesale DSL services. These benefits result directly from the existence of unbundling and the competition which has resulted.
- 3.11 Competitors are using their own infrastructure to deliver innovative services such as Optus' Fusion product (\$80/month for broadband plus telephony with unlimited local, long distance and calls to Optus Mobile) and iiNet's Naked DSL (\$49.95 for broadband – without the requirement to pay for line rental).
- 3.12 The competitive benefits of unbundling were recognised by the Chairman of the ACCC, Graeme Samuel, in a recent speech to the Australian Telecommunications Users Group:
- “Increased competition in the provision of broadband services has seen progressively lower broadband prices, increased data caps, better speeds and new innovation and products (such as naked DSL). This increased competition in broadband by other ISPs and carriers owes a significant debt to being able to obtain access to Telstra's copper loop. Competitors have this access through the declaration of the unconditioned local loop service (ULLS) and the line sharing service (LSS)”².*
- 3.13 The problem for policy makers to address is that under a network based on fibre-to-the-node (FTTN) technology effective unbundling will not be possible. The focus of interconnection today is the Telstra exchange, where competitors can locate their electronic equipment to access the Telstra copper loop. This will not be possible under an FTTN architecture since the Telstra exchange will be by-passed with electronics being deployed closer to the customer in a street-side node or cabinet. Whilst it will be theoretically possible to unbundle the network at the node, in economic and practical terms this will not be viable and by implication there will only be one NBN. The following diagram helps to identify the problem.

¹ Telstra “Local Carriage Service and Wholesale Line Rental Exemption Applications” – Supporting submission, 12 October 2007, page 2

² ATUG 2008 Annual Conference, Graeme Samuel – 13 March 2008



- 3.14 This means a reversal of the current regulatory policy trend towards facilities based competition and a return to a resale based access model. Without the correct regulatory settings for access to the NBN it is inevitable that Australia will lose the benefits from emerging facilities based competition in fixed line voice and broadband services.
- 3.15 The appropriate policy response to preserve competition in an FTTN/FTTH environment, regardless of who builds the network, is to ensure that there is structural separation between ownership and operation of the network.

Structural separation consistent with Labor's objectives

- 3.16 The G9 considers that structural separation is entirely consistent with Government's policy objective for the NBN. The Government has clearly signalled its requirements for a stake in the NBN through a Public Private Partnership model. In its policy document "A Broadband Future for Australia – Building a national Broadband Network" the then Labor opposition indicated that under a Rudd Government:

"Labor will use existing government investments in communications to provide a public equity investment of up to \$4.7 billion, which will in partnership with private sector deliver high-speed broadband across Australia". (emphasis added)

- 3.17 Whilst the Government's commitment to make funding available to help deliver the NBN is laudable, it is clear from the language of the policy that the

Government's objective extends beyond simply providing a financial subsidy towards construction of the network. By stating its intention to make an equity investment, the Government has signalled that it wishes to exercise the decision making rights in relation to the network that come as a necessary corollary of equity ownership.

3.18 It also follows that if the Government holds an equity stake in the entity which owns the NBN, then even if Telstra is the successful private sector bidder, the entity which owns the NBN will be partly owned by Telstra and partly owned by the Government. It will be a legal entity with different ownership to Telstra and under ordinary principles of company law it will be required to contract with Telstra at arm's length in supplying it with wholesale services. This is a structural separation model. G9 supports this model, and we consider it a necessary policy element if Australia is to build a NBN.

3.19 Further, in its policy document "A Broadband Future for Australia – Building a national Broadband Network" the then Labor Opposition identified a clear need for genuine open access arrangements to apply to the NBN:

"A pre-requisite for all proposals under this process is that they submit to providing a genuine open access to bottleneck fibre to the node infrastructure. Genuine open access would require:

- *Equivalence of access charges; and*
- *Fulls cope for access seekers to differentiate their product offerings by allowing the customisation of access speeds, quality of services and contention ratios."*

3.20 These commitments were recently reiterated in Minister Conroy's press release announcing the appointment of the Expert panel to consider proposals for the NBN, which indicated an expectation that the NBN would;

" have uniform wholesale pricing that offers consumers real value for money; and provide open access to wholesale broadband services on transparent, equivalent and genuinely pro-competitive terms and conditions".

3.21 The G9 supports the Government's objectives and strongly believes that competition will be central to delivering the Government's much anticipated broadband revolution. Competition over the national high-speed broadband network will facilitate the delivery of the most innovative services for consumers, schools and businesses at the lowest possible prices. Competition can best be preserved through structural separation.

3.22 The G9 intends to put a compelling proposal to the Government which will place competition and consumers interests at the heart of the NBN by ensuring that there is effective separation of interests between ownership of the network and downstream retail activities. This will address the many competition issues that have arisen from a vertically integrated access model and which have blighted the industry over the past decade.

Benefits of structural separation

- 3.23 As discussed above the structural separation of the FTTN is necessary in order to achieve a competitive and efficient telecommunications market. The tender of the next generation high-speed broadband network provides a unique opportunity to implement this necessary reform.
- 3.24 Under structural separation, the entity owning the NBN would have separate facilities, systems and staff and separate ownership from any retail operator, be that Telstra or any other operator. As a standalone business the incentives of the NBN owning entity would differ from those faced by Telstra today. As outlined above, today the bottleneck network owner is Telstra, a vertically integrated operator, which has the incentive to discriminate in favour of its downstream businesses. This incentive results in both price and non-price discrimination. Various examples were given above of ways in which Telstra discriminates against its rivals.
- 3.25 This incentive to discriminate can be contrasted with the incentives of the NBN owning entity under structural separation. This entity would certainly require continued regulation: it would be the owner of a network which would be the monopoly provider of fixed line high-speed broadband services and absent any regulation it would seek to charge unconstrained prices which were above cost. However, unlike the vertically integrated Telstra of today, it would not have an incentive to discriminate in favour of one particular purchaser of wholesale services (namely, Telstra Retail) and against all others.
- 3.26 The structurally separated network would therefore not need to be subject to a whole layer of regulation that would be needed if Telstra were to build the high-speed broadband network as a fully integrated provider. If, though, contrary to the G9's recommendation, the NBN were to be owned by a vertically integrated Telstra, then there would need to be an additional layer of very detailed and pervasive regulation. This would be necessary given the powerful incentive and opportunity for Telstra to abuse its vertical integration and sharply weaken fixed line competition. Some of the detail of what would be needed in that scenario is discussed below.
- 3.27 The incentive to discriminate is great because access seekers 'steal' business away from the vertically integrated Telstra, but the anticompetitive strategies that result from these incentives are difficult to detect and hard to police. In fact they are so difficult to detect and difficult to stop that structural separation is the right answer. In other words, it is impossible to design rules and implement regulation which prevent Telstra acting on its incentives to harm competitors.
- 3.28 For several reasons, there are great difficulties in relying solely on regulation to prevent anticompetitive conduct by a vertically integrated Telstra, meaning that such a strategy is very much a second best to structurally separating Telstra. These difficulties include the following:
- (a) Existing competition law is insufficient in an industry dominated by a monopoly owner of an essential service input into a potentially competitive downstream market. After more than ten years' experience, the conclusion is clear. Using either the telecommunications specific competition provisions of the Trade

Practices Act (Part XIB) or the general competition provisions of Part IV simply does not work to prevent Telstra's competitive abuses. It takes a long time. It is expensive. It requires complainants to discharge a burden of proof. In the fast moving telecommunications industry, Telstra can enjoy months and even years of benefit from anti-competitive conduct before the matter is investigated and sanctions imposed. Where the sanction is a competition notice, Telstra generally ignores it for months and ultimately pays a minor speeding ticket type fine to make the issue go away.

History demonstrates that competition law, including the Competition Notice arrangements, has not allowed matters to be considered in a timely manner and have been delayed by administrative challenges. These laws have largely been ineffective.

- (b) Telstra is adept at disguising as pro-competitive strategies which are in truth harmful to competition. For example, Telstra's pricing of wholesale DSL was structured to give access seekers negative margins on entry level services and high margins on high-speed services. Telstra argued that this was 'pro-competitive' because it would encourage migration to high speed services and put access seekers in a similar position to itself, it argued that it was supplying entry level services at losses and making money as customers migrated up the value chain. However, the reality is that there are little or no cost differences between low and high speeds services and the differential pricing was simply being used as a 'tool' to encourage greater usage. The effect of Telstra's strategy was to discourage competition for entry level customers and protect itself from long term competition by making low value (entry level) customers unprofitable for competitors even though they were profitable for Telstra because prices were still well in excess of marginal cost.
- (c) The rules may miss damaging anticompetitive strategies. Regulating access prices is almost universally focussed on the *level* of access prices, whilst competitive harm can come from the *structure* of access prices. Regulation has resulted in access prices that are equal to long-run average costs and imputation testing is done *on average* across market segments. This is despite the fact that Telstra, as a vertically integrated operator, faces the marginal cost of supplying services to particular segments of the market and prices at retail based on this cost structure. Imputation tests wrongly test for price squeezes *as if* Telstra paid the average cost of access and supplied all customers in the market, therefore leaving Telstra with the capacity to squeeze competitors and raise prices to end-users in particular market segments that are profitable for Telstra alone.
- (d) The rules required in the absence of structural separation would need to make fine distinctions. For example, there may be a rule preventing Telstra from engaging in anti-competitive price discrimination, on the grounds that its retail competitors cannot match such discrimination. But this needs to be weighed up against the benefits of price discrimination to customers (for example, by offering

lower priced services to customers who would otherwise be priced out of the market.) Defining acceptable and unacceptable price discrimination would be extremely difficult. A considerable virtue of structural separation is that such fine regulatory distinctions do not need to be drawn.

- 3.29 Inevitably the rules needed in the absence of structural separation must seek to differentiate between anticompetitive and pro-competitive conduct. History suggest that Governments, regulators and the Courts are reluctant to enact or implement rules that in any way risk limiting pro-competitive activity despite recognition that anticompetitive activity by Telstra is pervasive. This has created a merry-go-round of regulatory disputes and delay, legal challenges and rule changes. The cause of fixed line competition has been very poorly served.
- 3.30 That is why the policy case for structural separation of Telstra is a strong one. It has always been a strong one, quite independent of the arrival of a NBN. But there is a compelling case that neither Telstra nor any other party should be permitted to build an NBN unless it is structurally separated. Structural separation would mean that the high-speed broadband network owner would:
- (a) Have no incentive to engage in price or non-price sabotage against a particular access seeker;
 - (b) Engage in efficient pricing at the wholesale level rather than at the retail level. This ensures that all access seekers face the same true economic wholesale prices;
 - (c) Provide all access seekers with equal access to information important to their planning processes; and
 - (d) Have a lower cost of capital revealed in financial markets reflecting its lower risks as a standalone network owner.
- 3.31 Structural separation changes the incentives, and by changing the incentives the rules needed to address most anticompetitive strategies could be removed and the market structure would naturally deliver pro-competitive outcomes. These benefits have been recognised by the ACCC:
- “a vertically separated ownership model could reduce incentives for the access provider to discriminate between downstream users of the access service and, therefore, facilitate strong and effective competition between access seekers in retail markets.”³
- 3.32 Telstra has argued strongly against structural separation. This is not surprising because separation would remove from it the ability to engage in anti-competitive activity. In addition, Telstra’s managers are likely to fear competitive discipline of their activity. At present, resources and capital are allocated between Telstra’s retail and network division by management fiat. In a structurally separate environment, Telstra’s business divisions would be separate companies that would need to source capital from markets which

³ ATUG 2008 Annual Conference, Graeme Samuel – 13 March 2008

would judge them on their true business performance. Their individual business units would not be ‘protected’ from competition by anti-competitive strategies and as such they would, perhaps for the first time, face competition on their merits.

- 3.33 Telstra’s primary arguments in favour of vertical integration are summarised in an expert report by Ergas (2007) titled Vertical Integration, Vertical Separation and the Efficiency Consequences of the G9 SAU.⁴
- 3.34 Ergas (2007) identifies a number of benefits from vertical integration. The benefits identified are largely generic benefits of vertical integration relevant to any firm (e.g., avoiding double marginalisation, reducing transaction costs in co-ordinating activity and investment and other potential vertical externalities between firms). It is however an incomplete discussion because it ignores the reasons that firms do not vertically integrate and why the market would benefit from separation. The key reason is that the market is a better judge of resource allocations between activities than are firm’s managers. By Ergas’ logic all firms should vertically integrate because they would avoid double marginalisation and internalise vertical externalities. This is nonsense.
- 3.35 In a structurally separate market, access seekers (including Telstra’s retail business division) would compete in the open market for resources and capital and send price signals to the high-speed broadband network operator on where to invest, what services to make available and what quality of service to offer. These price signals are a fundamental part of market economies that are lost by vertical integration. In a vertically integrated firm these decisions are made internally rather than in the market.
- 3.36 As far back as 1937, Coase recognised that⁵:
- “.. in economic theory we find that the allocation of factors of production between different uses is determined by the price mechanism. The price of factor A becomes higher in X than in Y. As a result, A moves from Y to X until the difference between the prices in X and Y, except if so far as it compensates for other differential advantages, disappears. Yet in the real world, we find that there are many areas where this does not apply. If a workman moves from department Y to department X, he does not go because of a change in relative prices, **but because he is ordered to do so**”.*
[Empahsis added]
- 3.37 Whilst it is difficult to quantify in precise terms it appears that the costs associated with vertical separation identified by Ergas (2007) for Telstra are low. For example, despite substantial fixed costs in network services, retail operators in a competitive market are likely to have very limited market power and hence there is not likely to be a significant ‘double’ mark-up. Moreover, a structurally separate network owner will have the incentive to offer non-linear priced contracts to all access seekers to encourage use of its network (particularly under a price cap form of regulation) which contrasts with the

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<http://www.accc.gov.au/content/item.phtml?itemId=797540&nodeId=449ce937750b59d740b9722857705b29&fn=Telstra%20sub%20-%20annex%20%20-%20CRAI%20report.PDF>

⁵ R.H. Coase, *The Nature of the Firm*, 1937.

regulated vertically integrated operator (Telstra) who typically charges regulated access prices at long-run average costs to access seekers, creating a significant mark-up over marginal costs. In addition, there is likely to be the ability to co-ordinate investment between retail and network services via the market (or by contract rather than vertical integration) because there is likely to be limited amounts of sunk investment and the network owner has the option to go to many other retailers if they feel they are being held-up.

- 3.38 Notwithstanding the theoretical debate on the efficiency of vertical integration, the consequence of retaining a vertically integrated Telstra as the owner of the NBN is the continuation of insidious incentives to engage in anticompetitive conduct and a low likelihood of effective competitive in the market for high-speed broadband services.
- 3.39 Moreover there is increasing evidence to suggest that when the opportunities to engage in anticompetitive conduct are reduced, generally through tight regulation and effective operational separation, investors are recognising the gains from structural separation. Evidence is becoming clear in Ireland and New Zealand.
- 3.40 In summary, vertical integration of Telstra creates insidious incentives to engage in anticompetitive conduct because the vertically integrated Telstra will control access to an essential input into downstream markets which are potentially competitive. As discussed above, such incentives cannot be readily overcome by regulation. Hence, it is essential for Government to use the tender process to structurally separate Telstra.
- 3.41 As we have noted, the Government's policy effectively requires structural separation if Telstra wins the competitive selection process, because the network owning entity will be partly owned by Telstra and partly owned by Government.
- 3.42 The tender process provides a unique opportunity because the tender for the high-speed broadband network removes two of the historic barriers to the separation of Telstra being:
- (a) The costs of separation; and
 - (b) Identifying the point at which separation occurs.
- 3.43 In developing tender proposals and rolling out the network, Telstra (and other potential network operators) will define the scope of the network, its assets, personnel, costs and its relationship with other networks owned by Telstra (or the other network operator). As such, it will create the potential for the network to be split from the other activities and for the entity owning the network to enter into true arm's length contracts with other parts of Telstra.
- 3.44 Similarly, the move to a next generation network in the context of a tender proposal will identify a very clear point at which separation can occur and all access seekers can gain access to the transport layer on arm's length terms.

Ring-fencing requirements

- 3.45 If there is a likelihood of common ownership between the high-speed network owner and access seekers then some rules will need to be put in place that ensure 'open access' to network services. In our view this means implementing ring-fencing between the NBN owner and any jointly owned access seeker. (In this submission, we use the term 'jointly owned' to mean an access seeker, or retail telco, which is majority owned by an entity which also has an ownership stake, either directly or via intermediaries, in the NBN.) These ring-fencing provisions would include measure to ensure price equivalence and operational (non-price) equivalence.
- 3.46 In the context of access to monopoly network elements and services, open access refers to access that is free from terms that may lead to vertical foreclosure. Open access can be distinguished from closed access which refers to an arrangement in which there is full vertical foreclosure – i.e., where no access is provided to unbundled network elements or services. Closed access means that parties must compete on the basis of fully-integrated network and retail services.
- 3.47 An open access regime allows access seekers to have equivalent terms of access to basic network elements and services. This means that access seekers can compete 'on their merits' in the retailing of those services. That is, in an open access regime both price and non-price terms of access are not discriminatory as between different access seekers (retail telcos).
- 3.48 With a standalone network owner there are few incentives to discriminate between access seekers, particularly if the downstream (retail and wholesale) markets are competitive. Where the owner of the monopoly network operates in the downstream markets the risk of vertical foreclosure is high and the incentive to anti-competitively discriminate must be addressed by ring-fencing arrangements.
- 3.49 There are two key elements to effective ring-fencing arrangements – price and non-price terms.
- 3.50 The pricing provisions of effective ring-fencing arrangements include detailed imputation testing and rules regarding price discrimination.
- 3.51 It is widely accepted that a vertically integrated operator selling an essential input to its competitors has the incentive to squeeze the margins of those competitors in downstream markets. If the owner of the high-speed broadband network also has an ownership interest in an access seeker (retail telco) then it has the incentive to favour that access seeker by setting access prices that favour its operations.
- 3.52 Telstra has (audaciously) used a consultation by Ofcom to argue that vertical price squeezes are less likely to occur in a next generation network environment. In its submission to the ACCC on FANOC's undertaking Telstra quotes Ofcom as saying:

"... with retail minus and anchor product approaches, which involve greater pricing flexibility at the access level, there may be greater scope for margin squeeze compared to cost based forms of regulation. However, if a vertically

integrated next generation access investor is allowed to take profit from the upstream wholesale products then it has much weaker incentives to discriminate against rivals in the downstream markets. This, combined with the recognition that communications providers might help increase overall demand for next generation access could both act to diminish incentives to discriminate”

- 3.53 However, this argument amounts to saying that if Telstra is allowed to earn monopoly margins in its access prices it will have less incentive to harm downstream competitors. Whilst technically this incentive might hold, it yields a poor outcome for consumers because they are ‘guaranteed’ charges which are at monopoly levels by virtue of Telstra’s access pricing policy to allow monopoly rents. In any event, even if this were allowed, Ofcom recognise, in the paragraph following Telstra’s quote, that:
- “In the event of any complaints being raised on access terms, prohibition of margin squeeze would be covered by competition law, and could result in ex post price regulation as a result of complaints as opposed to ex ante price regulation of services. If this is a likely outcome, it may be more suitable to determine prices ex ante in order to provide clarity on the terms of access and to ensure that, before the conclusion of any margin squeeze assessment, no parties can gain a competitive advantage in terms of market share.”*
- 3.54 As previously indicated, the G9’s experience of Telstra’s behaviour is that given the mere whiff of an opportunity price squeezing “is a likely outcome”. Imputation testing is therefore a necessary component of a ring-fencing arrangement and the approach to imputation testing must be sufficient to detect the possible anticompetitive strategies of the vertically integrated network owner.
- 3.55 A network owner has the incentive to maximise profitable utilisation of the network, even when its overall revenues are regulated. As network costs are largely fixed, it is profitable to expand use of the network to users who are willing to pay more than (short-run) marginal costs (which are close to zero). This can be done profitably if price discrimination is possible, that is, if the network owner can charge some users a price more than marginal cost and others a lower price closer to or at marginal cost. This might be done by changing the characteristics of the wholesale service to make the low price service unattractive to those willing to pay a higher price, e.g., by significantly limiting the speed of the low priced service.
- 3.56 A standalone network owner will have the incentive to make these efficient access price structures available to all access seekers so they can be ‘passed-through’ to end-users. Price discrimination is likely to be a very important tool in encouraging use of high-speed broadband.
- 3.57 There is cause for suspicion, however, if a vertically integrated network owner does not make efficient price structures available to all access seekers. This is because the integrated network owner (as an entity) will face the marginal cost of the service rather than the higher (above marginal cost) access price faced by the access seeker if efficient price structures are not offered to them. This effect can be seen in current access pricing by Telstra. It prices wholesale line rental services at the average (retail minus) cost of providing them (at around \$26), however at retail it offers line rental services at prices of around \$32,

\$29, \$26 and \$18.⁶ As access seekers pay the charge of \$26 it is unprofitable for them to service customers at \$18 – meaning that even though the alternative access seeker may be more efficient than Telstra at retailing the service it cannot compete. There are a number of important points to note about this example;

- (a) Firstly, the customer who is only willing to pay \$18 is still profitable for Telstra because the marginal cost of the line is low (near zero);
- (b) Secondly, an imputation test across the market of all Telstra's customers may be passed, because some customers are willing to pay above \$26; and
- (c) Finally, if Telstra were a wholesale operator only (rather than a vertically integrated company offering services at both wholesale and retail levels) then it would have the incentive to offer access prices that would allow all access seekers to develop retail services that can service all customers, including those only willing to pay.

3.58 To ensure effective downstream competition an equivalent amount of price discrimination should be made available to all access seekers. To ensure it is truly being made available, the ring-fencing provisions must include imputation testing on a product by product basis. The consequence of a failed imputation test on a product must be swift and 'in-built' into the ring-fencing arrangement. The consequence should be that if any jointly owned access seeker offers a retail service which cannot be profitably matched by an equally efficient competitor then the network owner must offer a wholesale service that allows it to be matched. In this way, retail innovation and pricing can drive the market and ensure that the benefits of the network innovation are offered to all access seekers and in turn to all customers, not just those of the network owner's downstream affiliate.

3.59 Detailed non-price provisions are also needed in a ring-fencing arrangement. A standalone owner of the high-speed broadband network will engage in genuine arm's length transactions with access seekers. The standalone owner will have no incentives to discriminate between access seekers in its non-price dealings. For example it will have the incentive to:

- (a) Share information on product development, service specification and network operations with access seekers equally;
- (b) Protect confidential information;
- (c) Offer the full range of services to all access seekers; and
- (d) Facilitate efficient ordering, provisioning and fault rectification which integrate with each access seeker.

⁶ These line rental charges are offered on condition the customer pays various local call charges. They are structured such that depending on a customer's calling practices, only one package would be optimal to choose. Essentially, the packages offer high (low) price line rental and low (high) local calling charges that allow low-use users to get a low price that would not be attractive to high-use users. This is a common form of price discrimination which would be practiced on a high-speed broadband network.

- 3.60 In contrast, a vertically integrated network owner has significant incentives to give preferential treatment to its retail (and wholesale) operations. These incentives cannot be fully addressed without ownership separation. If ownership separation is not contemplated the ring-fencing arrangements must provide for both controls which limit the ability of a vertically integrated network owner to favour its downstream operations and arrangements to ensure non-discriminatory treatment of all access seekers.
- 3.61 These controls and arrangements would require the network owner to:
- (a) Establish and maintain separate accounts and reporting for its network business and any downstream businesses;
 - (b) Provide wholesale access to all services provided by the network to all access seekers;
 - (c) Have identical non-price terms and conditions for all services provided on the network (or quality adjusted prices) for all access seekers;
 - (d) Undertake genuine arm's length transactions by allowing all access seekers (including any jointly owned downstream operations) to access the same platform for ordering, provisioning, invoicing, billing, fault rectification and reporting;
 - (e) Prohibit information sharing between network and jointly owned downstream businesses (both retail and wholesale) by separating IT systems, prevent staff sharing and prohibiting management overlaps;
 - (f) Separate marketing and service development functions between network and jointly owned downstream businesses; and
 - (g) Have independent oversight over controls between network and jointly owned downstream businesses.
- 3.62 To ensure there is ongoing equivalence in both price and non-price terms of access and that the ring-fencing provisions are effective, the G9 recommends that the ACCC be given an ongoing oversight role in approving terms of access to the NBN.

RFP provides a clear opportunity for Government to help shape the necessary policy reform

- 3.63 In the previous section we have outlined the key regulatory reforms that need to be implemented with the roll-out of the NBN. The RFP provides the Government with a clear opportunity to ensure that proposals are tailored to an appropriate regulatory framework that will help maximise delivery against the Government's key objectives.
- 3.64 In particular, we recommend that the Government takes the opportunity to spell out the minimum criteria must be met to achieve "genuine" open competitive access. This should include;

- (a) a clear requirement that the network entity that will build and operate the NBN should be structurally separate from any downstream retail arm; and
 - (b) that any proposal which involves a common ownership between an entity that will build and operate the NBN and a downstream retail entity must put in place clear ring-fencing provisions to prevent any discrimination in both price and non-price terms of supply;
- 3.65 Any proposals that do not address these minimum requirements should be considered non-compliant.

4. Content and Process issues relating to the RFP and selection process

- 4.1 The task that has been assigned to the Expert Panel is of critical significance to the Australian telecommunications industry and to the welfare of all Australians, now and well into the future. Given the increasing importance of telecommunications to the economy, to the delivery of essential services such as education and health and to all aspects of daily social interaction, the terms on which any high speed broadband network is constructed, and the entity that ultimately controls the network, will have wide ramifications, not just for the telecommunications industry, but for all Australian consumers and businesses.
- 4.2 It is, therefore, essential that decisions in relation to the network are made with due and appropriate consideration, with long term national interests in mind, and with an adequate opportunity for proponents to provide the Expert Panel with information that is of a quality and level of detail that is in keeping with the magnitude of the decision being made. The RFP should be designed to ensure that all aspects of a proposal that might influence competitive outcomes are identified.
- 4.3 It is also important that the selection process is designed to create the maximum level of competitive tension between the various proposals. This will enable Government to make the best possible choice – and secure the best outcome for all Australians.
- 4.4 It is important, therefore, that the RFP is crafted with due care and attention. In the following section the G9 has outlined some of the important issues that need to be addressed or reflected in drafting the RFP.

Assessment criteria

- 4.5 The G9 submits that clear criteria need to be given to guide the assessment process. The criteria must allow a transparent, rigorous and objective assessment of the proposals.
- 4.6 The over-arching criterion should be the long-term interests of end-users and any proposal should be assessed first and foremost through the prism of consumer outcomes. In other words, the assessment of proposals should adopt a consumer welfare standard.⁷ That is, elements of each proposal

⁷ Under a consumer welfare standard the proposal with the lowest price will be chosen when other things are equal. The alternative is a 'total welfare' standard. Under a total welfare standard, the proposal with the lost cost will be chosen even if it has the highest price (other things being equal). This is because under the total welfare standard

should be assessed and valued by their relative contribution to consumer welfare. The RFP should be explicit regarding how performance against each criterion will be measured and how performance will be measured across all criteria. That is, how performance against each individual criterion will be 'added up', 'balanced' or 'weighted' when comparing proposals.

4.7 Each proponent should be required to assess the impact of their proposal on consumer welfare and provide the detail of their analysis (forecasts, assumptions, etc) for public consultation and independent assessment.

4.8 The G9 submit that the following should be the primary criteria in assessing each proposal:

(a) Geographic coverage and rollout schedule;

Increasing coverage is desirable so long as the incremental value to consumers exceeds the incremental cost of providing the service – even if incremental revenues do not exceed incremental costs.

Each proponent will seek to propose extending the network into areas where the incremental revenues exceed cost, however, there will be areas where it is 'efficient' to extend coverage but where the incremental revenues do not cover incremental costs. This will always be the case where the infrastructure owner's pricing does not allow them to 'perfectly price discriminate'⁸. However, while it is efficient to extend coverage to such areas this will inevitably result in other areas paying higher prices – as the shortfall in revenues from the higher cost areas must be recovered in some manner. The higher price to customers in other areas will reduce their consumer surplus⁹. However, this reduction in consumer surplus will, by definition, be less than the increase in consumer surplus in the areas to which broadband has been extended.

The RFP should therefore be clear about whether the Government is seeking proposals which either:

- Minimise the price paid by customers receiving the service; or
- Maximises the total consumer surplus for all customers.

By being explicit about its criteria Government will attract proposals which are targeted at achieving the Government's objectives and maximise the value of its equity contribution of \$4.7 billion.

higher prices result in higher profits which are valued as highly as consumer surplus (even if they are a transfer of surplus from consumers to the network owner).

⁸ Perfect price discrimination describes a situation where the seller is able to set all prices exactly equal to (or infinitesimally below) the full value consumers place on that consumption. As a result, the sellers revenue is exactly equal to the consumer's valuation of the services (ie., there is no consumer surplus).

⁹ Consumer surplus is widely used as a measure of economic welfare and as the basis for assessing the welfare impact of regulatory or policy decisions. In general terms, the consumer surplus represents the difference between the amount users of a service actually pay and the amount they are willing to pay.

As the construction of the high-speed broadband network is likely to take some time it would be useful to include criteria which guide proponents on the development of their rollout schedule. Whilst price might be minimised by rolling out to areas of least cost first, consumer surplus (in a net present value sense) will be better promoted by a “roll-in’ strategy, whereby service deployment is prioritised to areas which do not currently receive competitive high-speed broadband first.

(b) Quality of service;

Similar to coverage, increasing quality of service is desirable so long as the incremental value to consumers exceeds the incremental cost of providing the higher quality service – even if incremental revenues do not exceed incremental costs.

Quality of service on a high-speed broadband network may, for example, be reflected in the bandwidths available and/or the congestion on the network.

The RFP should provide clear guidance about whether the Government is seeking to:

- Minimise the price paid by all users receiving services – therefore high quality should only be offered if incremental revenues exceed incremental costs; or
- Maximise the consumer surplus for all customers – therefore high quality should be offered if consumer valuation exceeds incremental cost.

(c) Regulatory pricing model; and

Consumers benefit from prices that reflect the efficient cost of supply.

The regulatory pricing model proposed by proponents is the essence of any bid and should be a key focus of the assessment in terms of the outcomes it delivers consumers. The RFP should expressly require parties to demonstrate how their proposals provide incentives for costs to be efficiently incurred and that only efficient costs are passed through into prices.

In addition, the RFP should require parties to demonstrate the efficiency of their financing. The allowed return on capital has a material effect on prices for consumers and will be a major point of differentiation between proponents.

The G9 submits that criteria and process should be developed so as to reveal parties’ ‘true’ cost of capital – this is after all one of the main benefits of going through a tender process. In a report on economic analysis of sub-loop access the Competition Economists Group has noted that¹⁰:

¹⁰ http://www.ceg-ap.com/templates/cec/page/page_html_standard.php?secID=139

“As the monopoly owner of the sub-loop Telstra has an incentive to hold up investment in the deployment of a fibre network (either by itself or a third party) to secure regulated terms of access that are above cost.”

The Taskforce should develop a process in which the terms of the build (e.g., the network design, services and regulatory model) are separated from the required financing. This would allow the taskforce to deal with a situation in which the preferred network design and service construct was being bundled with an unattractive regulatory pricing model which sought a return on capital in excess of what other equity investors would accept. This issue has been brought into sharper focus with Telstra’s recent jaw-dropping claim that it requires a return on its investment at a level that is “north of 18%”.

The G9 has proposed a capital raising auction in its special access undertaking. We submit that this concept could be developed by the taskforce to minimise the risk of accepting a pricing model which has an extortionate return on capital.

(d) Competitive effect.

Consumers benefit from competition. They benefit from the increased choice that competition provides and the incentives to lower costs and drive prices towards efficient costs. Adopting a consumer welfare standard will appropriately put a high value on the competitive effect of proposals. This is because lower prices due to improved downstream competition will come at the expense of lower profits. Under a consumer welfare standard those lower profits are ignored.

Each proponent should outline how their proposal will facilitate competition. Particular elements of the proposals will likely have a substantial impact on;

- Service definitions – the G9 supports the position of the ACCC in its assessment of FANOC’s special access undertaking in which it outlines the minimum elements of an FTTN access service.¹¹ In particular, the G9 consider it is in the interest of consumers to have services defined which allow maximum unbundling and differentiation. For example, proponents should be assessed on whether the ‘voice’ service they offer is one that allows differentiation or whether it is more like today’s Telstra offering of wholesale line rental which limits access seekers’ ability to differentiate services in terms of quality, price structure and service ordering and billing.
- Point of interconnection – the location of the point of interconnection is likely to have a substantial impact on

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[http://www.accc.gov.au/content/item.phtml?itemId=806090&nodeId=4c6aac5ae5acc43dcb477d74fcc8d17c&fn=ACCC%20draft%20decision%20on%20FANOC%20SAU%20\(Dec%2007\).pdf](http://www.accc.gov.au/content/item.phtml?itemId=806090&nodeId=4c6aac5ae5acc43dcb477d74fcc8d17c&fn=ACCC%20draft%20decision%20on%20FANOC%20SAU%20(Dec%2007).pdf) (page 60-62).

competition. The deeper into the network the POIs are located, and the more numerous are the POIs, the more opportunities there are for access seekers to control and differentiate the service, use their own facilities and lower costs. These are the essence of competition and the benefits of unbundling. Proponents should be required to outline the effect of different points of interconnection on their costing and pricing and their impact on competition. To the extent any bid includes the utilisation of existing infrastructure and services, then the costs attributable to those network elements must also be disclosed in the bid.

- Market structure delivered by the proposal – if there is joint ownership between the network owner and any access seeker then the proposals should be ‘marked down’ because of the likelihood of competitive distortions in the downstream market for broadband and telecommunications services. The criteria should invite proponents whose proposals allow joint ownership to outline ring-fencing arrangements that will be put in place to lessen the anticompetitive effects, prevent measures to raise rivals’ costs and ensure an open, non-discriminatory access model.

Regulatory costing and pricing issues

- 4.9 The tender for the high-speed broadband network will shape much of the telecommunications regulatory framework for the foreseeable future. Piggy-backing on the copper local loop, the network will provide basic telephony and fixed line broadband services to the majority of Australians.
- 4.10 The access arrangements to this network will determine the scope of competition. The G9 welcome the Government’s commitment to an open access model and the Government’s willingness to take the advice of the ACCC in relation to the regulatory framework for this network.
- 4.11 The architecture of most next generation access networks will, perhaps ironically, increase the scope of the economic bottleneck. Today the economic bottleneck has been narrowed to the unbundled local loop, but in a fibre to the node network the economic bottleneck will extend beyond the local loop to include the capability of the DSLAM and fibre transmission. This change makes it critical that regulation is strengthened, as it will now carry much more of the burden of ensuring competition.
- 4.12 The G9 submit that the regulatory model should be one that delivers outcomes which are in the long-term interest of end-users. It should encourage efficient investment in infrastructure, but not investment at the expense of competition.
- 4.13 In its special access undertaking the G9 has proposed what it considers to be a reasonable methodology for turning efficient costs into prices. It provides:
- (a) Incentives to incur efficient costs;
 - (b) Incentives to structure prices in an efficient manner;

- (c) A cap to ensure that revenues do not systematically exceed costs;
 - (d) Arrangements to give investors a reasonable return on capital which reflects their true costs of capital; and
 - (e) For a continued oversight role for the ACCC in the regulation of telecommunications.
- 4.14 The G9 submits that these are all essential components of any regulatory model for the regulation of the high-speed broadband network and that the tender documents should reflect these essential components.
- 4.15 In addition, the G9 submit that the tender documents should require that the regulatory pricing model includes a 'no disadvantage test'. That is, the tender documents should require the proponents to outline the arrangements it will put in place to ensure that no retail customer is disadvantaged by the changes to the network.
- 4.16 This test would require the proponent to outline an imputation analysis for each of its service offerings which show how all existing customers receiving telephony and broadband services (including customers served by Telstra at ADSL speeds and customers served by access seekers today using ADSL2+ via the ULL) will be able to receive the same services at the same price after the new network has been built. Note that this requires that the replacement services provide access seekers, and in turn retail customers, with the same flexibility of service offering as they can make available today using the ULL. That is, the replacement services would not satisfy the 'no disadvantage test' if they provided materially less scope for service differentiation. For example, the current wholesale line rental and local carriage services would not pass such a test as they would not give access seekers flexibility regarding line services (including voicemail, call back, etc), billing and packaging as is available today using the ULL. Similarly, the replacement broadband services would need to provide the same flexibility as exists today using the ULL.
- 4.17 In making this submission the G9 does not support the 'anchor regulation' approach floated by Ofcom, or at least the version of anchor regulation that is described by Ofcom as 'static' in which:¹²
- "... the anchor product is defined and priced at the start of the regime such that consumers are not made worse off by taking the product ...[but where]... [t]he anchor definition and price do not vary over time, and the next generation access platform operator has pricing and product flexibility over all other products deployed on the next generation access platform"*
- 4.18 The G9 submit that this approach would be inconsistent with the Government's commitment to an open access model in which consumers get the benefits of access to next generation access network services in a market which is as competitive as is possible.

¹² http://www.ofcom.org.uk/consult/condocs/nga/future_broadband_nga.pdf (page 101)

Price and non-price terms to be approved by the ACCC

- 4.19 As indicated earlier in this submission, the G9 proposes that the ACCC should have a clear role in approving both the price and non-price terms for access to the NBN.
- 4.20 To give effect to this principle, the G9 recommends that by far the most efficient approach is for the RFP to require that proponents have a Special Access Undertaking (SAU) accepted by the ACCC. This is similar to the approach that has been adopted in respect of the allocation of the Channel B licences under the Broadcasting Services Act. The Channel B licence will allow the provision of mobile TV services and is likely to be the only spectrum in the broadcasting services band that will be available for the provision of such services, prior to the switch-off of analogue television. For this reason, the holder of the Channel B licence will have a short term monopoly that would have the potential to significantly impact upon the broader telecommunications market.
- 4.21 Therefore, in the case of the Channel B licence the Government has appropriately ensured that prior to the allocation of the licence, the bidder must have a special access undertaking accepted by the ACCC, which sets out the terms and conditions on which third parties will be given access to the service. The high speed broadband network will be a monopoly of far greater scope, scale and durability than the monopoly created by the granting of the Channel B licence. Therefore, it would be appropriate for the same requirement to apply.
- 4.22 The requirement to have a special access undertaking accepted by the ACCC would provide a clear method for the Government to ensure that the commitments that are made as part of the assessment process in respect of the provision of wholesale access and pricing principles are actually enforceable by the ACCC, following the construction of the network and the commencement of the provision of services. In addition, the ACCC would be able to take enforcement action in the Federal Court if the access provider was not complying with the terms of the relevant undertaking.
- 4.23 This of course would not mean that the Expert Panel could simply assess network structure on its own, without any regard to the structure of the applicant entity and the pricing principles proposed. As discussed above, in order for network and operational characteristics to be assessed against the LTIE, consideration will necessarily need to be given to the market structure and competitive environment that will result from the construction of the network. Therefore, the Panel would certainly need to give consideration to the proposed price and non-price terms of access. However, the more detailed analysis of that aspect of proposals could be conducted by the ACCC.
- 4.24 The requirement to have an SAU accepted by the ACCC need not delay the process for selecting the winning bidder. The ACCC's consideration of the appropriate access arrangements that should apply to an FTTN network are well advanced, given the extensive work it has done in assessing G9's SAU. We recommend that the RFP should require parties to submit an SAU to the ACCC no later than the date they lodge their proposal to the Expert Panel. This should enable the ACCC to reach a decision to accept or reject that undertaking by the third quarter of this calendar year.

Transition arrangements to be specified

- 4.25 The Government's requirement that the NBN is to be predominantly based on FTTN technology will likely result in disruption to existing services provided off Telstra's copper loop. This is because the FTTN will be built as an overlay network on the copper loop, with use of the last few hundred metres of the existing copper runs into customers' premises.
- 4.26 The NBN will necessarily impact the provision of services to existing customers. It is important, therefore, that the RFP requires all proponents to outline how their proposal will impact existing services, both to retail and wholesale customers. They should also be required to identify the detailed transitional arrangements they propose to put in place to ensure continuity of service and minimise any disruption to all existing customers who will be affected by the network changes. Proponents should be invited to compare their solutions to alternatives considered but not proposed.
- 4.27 The importance of this requirement was recognised by the ACCC in its assessment of G9's Special Access Undertaking:
- "A smooth migration to the new service for current access seekers and their customers would also be critical".¹³*

Compensation

- 4.28 It is highly likely that the NBN will involve overbuild of existing infrastructure resulting in some or all components of that infrastructure becoming stranded. This will inevitably give rise to potential compensation claims from those investors whose assets become stranded.
- 4.29 It is essential, therefore, that the RFP require all bidders to provide details of the arrangements they propose to provide appropriate compensation to parties who might be affected by the roll-out of the NBN (including compensation for stranded DSLAM investments).
- 4.30 It also follows that bids that target roll-out schedules and transitions that avoid stranding competitive assets could be "marked up" as more favourable to bids that immediately target more competitive existing exchange areas. This is largely as a function of the cost savings that flow from the avoidance of unnecessary stranding and therefore unnecessary compensation.

Legislative changes

- 4.31 If the proponent requires legislative amendments or regulatory changes as a condition of their proposal then these should be outlined and proponents should be required to provide an impact assessment of their proposals on the long-term interests of end-users.
- 4.32 For example, if a proponent is seeking protection from ACCC oversight under Part XIB or XIC of the Trade Practices Act, then it should outline the

¹³ Assessment of FANOC's Special Access Undertaking in relation to the Broadband Access Service – Draft Decision – December 2007, page 5.

consequence of such protection. Similarly, if a proponent is seeking protection from over-building of its assets (as the G9 has indicated) it should outline the impact on end-users. To the extent that any bid is contingent upon significant lessening of obligations in respect of the provision of wholesale services to competitors under the Trade Practices Act, which we understand to be the case in relation to Telstra's previous negotiations with the Howard Government, then that bid should be declared non-compliant. As a minimum the negative effect on competition of such changes would need to be taken into account in assessing all other aspects of the relevant proposal.

- 4.33 In addition, proponents should be required to outline how compliance will be achieved with other legislative and regulatory arrangements applying to the telecommunications industry - including consumer protection, price controls, universal service, pre-selection and interconnection.
- 4.34 Finally, parties will need to outline the 'public private partnership' structure in which they will accept any contribution from Government. The merits of any proposed structure should be judged according to the return (if any) provided to Government, the risks transferred to Government and the control allowed by Government, including how any conflicts of interests would be addressed.

Proposals for Specific 'Modules' of population coverage

- 4.35 To maximise competitive tension and ensure transparency the G9 recommends that prospective bidders should be encouraged to submit modular proposals or ensure that any bids covering 98 per cent of the population are required to provide specific details of the costs of specific 'modules' of coverage.
- 4.36 A process requiring a single bid will significantly reduce competitive tension as Telstra may be able to use its superior scale and network reach to deliver a national bid on terms that no other bidder can replicate.
- 4.37 Telstra has a tremendous cost advantage in serving many rural and remote locations, particularly because it has a much more extensive network of backbone transmission fibre than its competitors. For example, Telstra is the only company which owns fibre running from Adelaide to Darwin. The cost of building a new transmission fibre from Adelaide to Darwin would be several hundred million dollars.
- 4.38 This is not a material issue for a build to the capital cities, or to the capital cities and major regional centres. In fact, we estimate that around 80% of the population cumulatively (the capital cities plus major regional centres) can be served by a network which does not draw significantly on Telstra's transmission network. But in serving the remaining 18% of the population required to be served under the Government's policy, Telstra will enjoy a very substantial cost advantage over its competitors.
- 4.39 In turn, this means that on a national bid basis, Telstra will enjoy a substantial 'price shield' – and the competitive selection process may well not put Telstra under substantial price pressure. This problem can be addressed by a modular approach. For example, bidders putting forward national proposals could be asked to submit these in two modules: one to serve the first 80% of

the population, and one to serve the last 18% of the population. The Government would be free to accept one module from one bidder and one module from another. For each module, a bidder would be required to specify the subsidy it required and the prices it would charge – and in specifying this, the bidder would be required to assume that it did not win the other module.

- 4.40 If this approach is not attractive to Government, then as an alternative we recommend that proposals covering the full 98% coverage requirement are broken down into specific modules of coverage.
- 4.41 Either approach will ensure transparency and maximise competitive tension in pricing. In particular, it will force Telstra to be transparent in revealing the subsidy it would require to serve the last 18%.
- 4.42 To maximise competitive interest and encourage innovative ideas, the Government should not discourage proposals for more discrete coverage areas.

Two stage process

- 4.43 A further measure to maximise competitive tension would be to allow for two stages in the bidding process.
- 4.44 Prospective bidders should be required to submit an Expression of Interest ("Eoi") as part of a prequalification phase. The Eoi phase would allow the Government to gather information on the proposed bids and to gauge the level of demand. Following this Eoi phase, shortlisted bidders would be selected to develop and submit more detailed, legally binding tenders as part of a final assessment phase.
- 4.45 This approach is consistent with the current Singapore Next Generation National Broadband Network process and comparable procedures internationally. It has the merit of encouraging prospective parties to come forward with proposals without initially requiring them to commit to legally binding bids. This is likely to increase the level of interest in the selection process and encourage more innovative ideas to be developed than otherwise might be the case.
- 4.46 This two stage process would also have the attraction of enabling bids lodged in the EOI phase to be united to form stronger, more competitive amalgamated bids in the final phase.

Timeframes

- 4.47 Whilst the G9 recognise the Government's stated ambition to have selected the preferred bidder and commenced the roll-out of the NBN by late 2008, the need for a speedy decision should be balanced against a process which maximises the number of serious bidders who participate. If the process is too rapid, there is a real risk that Telstra as the incumbent will enjoy an insuperable advantage – and the competitive tension in the process will be lost.

- 4.48 Further, as discussed earlier in this submission the roll-out of the NBN requires the government to make some important and complex decisions about the regulatory framework. These decisions are likely to necessitate industry consultation and legislative change. If these issues are given insufficient consideration in the rush to achieve an outcome this could result in long-term adverse consequences for industry and consumers.
- 4.49 This infrastructure is likely to form the bedrock for broadband and telecommunications services well into the future. It is important that decisions taken today are given due consideration. This means that the timeframes set for the selection process should be realistic giving parties an appropriate time to prepare bids and the Panel and Government time to carefully assess them. If this means that additional time has to be allowed for in the process then Government should take that necessary time in the knowledge that the competitive side of the industry will support it.

RFP should be technology neutral

- 4.50 Whilst the G9 recognises the Governments' policy commitment to a *minimum* 12Mbps using a fibre to the node network solution, we recommend that the RFP should not prescribe a technology but leave open the option for alternate technologies to be deployed.
- 4.51 This will give Government the opportunity to test whether there are other technologies which could deliver the same – or a superior – outcome for a better price.
- 4.52 We recommend that the RFP specify that the Government's minimum requirement is the delivery of bandwidth and pricing which could be achieved using a fibre to the node network – but that the Government remains open to consideration of alternative delivery mechanisms that can achieve those minimum requirements.
- 4.53 We believe that a specific benefit of this approach is that it would allow the Government to test whether there are technologies which could deliver the required bandwidth and pricing in rural and remote areas more cost-effectively and quickly than could be achieved with fibre-to-the-node. It is well accepted that as population density falls, there is a breakeven point achieved at which wireless and satellite technologies become more cost effective than fixed network technologies such as fibre to the node.
- 4.54 An important additional benefit of wireless and satellite technologies is that they can be rolled out much more quickly than a fixed network. Given that the Government's objective is for a rollout which is both extremely broad (going to 98% of the population) and extremely rapid (within 5-years), it may well be that the use of wireless technologies would help to achieve the objective. The way to find out, is to allow for such proposals to be brought forward in the competitive selection process.
- 4.55 The criteria should however, require parties to demonstrate the ability of their technical solutions to deliver the Government's minimum requires and any claims regarding their solutions capabilities. The criteria should also require

parties to provide an assessment of their solutions ability to be scaled and upgraded over time.

Equitable access to information

- 4.56 To maximise the prospect of obtaining compelling bids from parties other than Telstra, it is important that all bidders have equitable access to this information. Of particular importance is for all parties to have access to detailed information on the physical location of Telstra's existing PSTN and its constituent elements (exchanges, ducts, pillars, fibre and copper). The G9 proposal, for example, involves the extensive use of Telstra network elements under access arrangements. Other bidders may well take a similar approach. It will be critical for the G9 and other parties to have access to this Telstra information to enable them to submit a final, legally binding bid.
- 4.57 Without access to this information, Telstra will have an enormous advantage – and the process is much less likely to secure a worthwhile outcome.
- 4.58 The G9 recognises that the Government has taken steps to obtain this information and we understand that there are plans in place to make this information available to bidders under appropriate confidentiality arrangements. In process terms, assuming our recommendation for a two step process is adopted, we recommend that this information be provided prior to the final assessment stage so that all short-listed bidders have an equal and fair opportunity to submit a detailed and accurate proposal.

5. *Other important process issues*

- 5.1 This section provides G9's recommendations in respect of issues that are of more relevance to the broader selection process.

Engagement Model

- 5.2 The proposals that will be lodged with the Expert Panel are likely to be extensive and complex. It will be important, therefore, for the Expert panel and its advisors to have an opportunity to engage face to face with bidders. This will provide an opportunity for the Panel to better understand the proposals and to clarify any features that are not immediately apparent from the written documentation.
- 5.3 The G9 recommends that as part of the assessment process the Panel provides a formal opportunity for each party to present its proposal to the panel and to answer questions from the panel and its advisors.
- 5.4 We also propose that the Expert panel publishes key elements of each proposal (excluding material that is clearly commercially sensitive) and allows for public comment on those proposals. We make this recommendation because such a process is likely to provide the Expert Panel and Government with additional useful commentary on each proposal – in particular it will enable industry to sanity check through real life experience the claims made by each of the proponents.

Legislative Reform package

- 5.5 It is highly likely that Government will have to introduce a legislation to give effect to any package of regulatory reforms associated with the NBN. This will be a very significant piece of legislation for the industry and will, for the reasons articulated in this submission, have a significant bearing on whether the NBN delivers the consumer benefits that the Government hopes for.
- 5.6 For this reason it is important that the industry and other stakeholders are given an opportunity to comment on the proposed legislation prior to its introduction to Parliament.