



**MODEL PRICE TERMS AND CONDITIONS FOR
PSTN, ULLS AND LCS**

SUBMISSION TO THE ACCC BY AAPT LIMITED

APRIL 2003

Introduction

- 1 This submission responds to the Australian Competition and Consumer Commission's Discussion Paper entitled *Model Price Terms and Conditions for PSTN, ULLS and LCS* dated April 2003.
- 2 It does so in the context of AAPT having made a submission to the Commission on access deficit contribution (**ADC**) issues in February this year¹ and AAPT's ongoing participation in the assessment by the Commission of Telstra's undertakings of January 2003 for PSTN originating and terminating access (**PSTN OTA**), the unconditioned local loop service (**ULLS**) and the local carriage service (**LCS**) (collectively, **core services**). Most importantly, AAPT anticipates that it will lodge with the Commission a detailed submission regarding Telstra's undertakings. This submission will include comments in relation to the appropriate determination of pricing for the wholesale supply by Telstra of the core services and will therefore also be relevant for determining appropriate model price terms.
- 3 As the Commission is aware, Telstra is making available to industry participants certain information in relation to its new economic cost model, PIE II. Telstra gave AAPT a presentation about PIE II earlier this month and AAPT has now made a written request of Telstra for specific information relevant to its assessment of the model.² It is not possible for AAPT to comment meaningfully on any of the modelling issues until it has completed its review of the PIE II model and Telstra has provided AAPT with the information AAPT has requested.
- 4 In these circumstances, AAPT believes it is premature for it to comment on many of the issues raised in the Commission's Discussion Paper. Nevertheless, it comments on certain matters below. AAPT reserves its ability to comment further on issues in the context of the Commission's consideration of model price terms and conditions for the core services as well as in relation to the Commission's assessment of Telstra's undertakings.

¹ "The need for an ADC for PSTN access service pricing", submission to the ACCC by AAPT, February 2003.

² Letter from AAPT to Telstra dated 24 April 2003.

Future setting of prices – the general approach

5 AAPT has previously indicated certain general views on the general approach to the future setting of prices for the core services.³ Its position, in summary, is as follows:

- (a) an updated TSLRIC model should form the basis for determining PSTN OTA and ULLS charges;
- (b) the updating should occur every three years;
- (c) indicative prices should be published annually and for two years into the future;
- (d) the use of adjustment factors for the purpose of arriving at indicative future prices should not supplant or dilute the legislative role of the Commission under Part XIC of the *Trade Practices Act, 1974 (TPA)*, particularly its responsibility for arbitrating notified access disputes under Division 8. The Commission is required by law to have regard to certain criteria including the long term interests of end users;⁴ and
- (e) as a consequence, the circumstances potentially relevant to an individual adjustment of the model prices should not be confined to a specific form of adjustment factors. The flexibility to take into account such matters and circumstances affect the relevant statutory criteria needs to be preserved.

6 AAPT is conscious that a consideration of the setting of model price terms involves a balancing of considerations, including the desire for greater certainty so that negotiations are conducted more effectively. AAPT believes that the approach summarised above will significantly assist the negotiation process, but at the same time it should permit flexibility so that the Commission can communicate to the industry in a timely way any significant developments relevant to pricing and the parties may, if the circumstances warrant, proceed to arbitration.

Range versus Point Estimates

The Commission invites parties' comments on the publication on a range of indicative prices, rather than point estimates.

7 AAPT supports the publication of a range of prices rather than point estimates when setting indicative prices.

³ "Future access pricing approaches for PSTN, ULLS and LCS", submission by AAPT to the ACCC, September 2002.

⁴ See generally sections 152AH and 152CR of the TPA.

8 The main difficulty with point estimates arises from uncertainty. After identifying the sources of uncertainty, the Productivity Commission observed:

“... it is plausible that the band of uncertainty around the midpoint estimate of PSTN access prices is approximately plus or minus 30%”⁵

9 In AAPT’s submission, it is this uncertainty which justifies the publication of a range rather than any consideration of whether the costs of error are asymmetric around the optimal access price.⁶

PIE II assumptions and inputs

The Commission is interested in parties’ response to the issues set out in the undertaking discussion paper on these matters, with any appropriate additions, for the purpose of submitting response to this paper.

10 As noted above, AAPT has yet to receive information directly relevant to its assessment of PIE II. Until that information is received and is considered, AAPT is not in a position to comment meaningfully on the assumptions and inputs used in the PIE model.

11 AAPT does, however, support the Commission’s general observation that a TSLRIC model will be sensitive to several parameters, including the weighted average cost of capital (**WACC**), and that it is important that the inputs used in any model are consistent with the legislative criteria.

Cost adjustment factors

In addition to the questions posed in the Commission’s undertaking discussion paper identified above, the Commission is interested in the views of interested parties on how it should calculate the technology factor and the output factor for the purpose of calculating adjustment factor for PSTN O/T conveyance cost and ULLS adjustment factors.

12 AAPT is concerned that the calculation of point estimates of the adjustment factors by the Commission will be unnecessarily prescriptive and will interfere with the promotion of commercial agreements. In order that any such interference is minimised, and in order that uncertainty regarding the adjustment factors is taken into account, AAPT submits that a range of indicative adjustment factors is appropriate.

13 AAPT further submits that any calculation of the adjustment factors that the Commission undertakes should reflect the forward-looking nature of the

⁵ Productivity Commission “Telecommunications Competition Regulation”, Report No. 16, September 2001, page 629.

⁶ See the discussion in Productivity Commission, “Telecommunications Competition Regulation”, Report No. 16, September 2001, pages 630 to 633, including the summary of AAPT’s argument in box D.3.

telecommunications access regime. This suggests that calculation of both the technology factor and the output factor should have due regard to best practice benchmarks.

Technology factor

14 In the literature concerned with incentive-based regulation, there is debate over the factors which are appropriate to consider in setting the technology adjustment factor. The debate is centred around the question of whether the technology factor should be set with reference to the specific costs and profits of the regulated firm or with reference to more general measures of expected productivity improvements.

15 AAPT supports the use of general measures of expected productivity improvements in determining the technology factor. This is consistent with Recommendation 12.2 in the Productivity Commission's Review of the National Access Regime:

“The Commonwealth, States and Territories, through the Council of Australian Governments, should initiate a process to develop further the productivity measurement and benchmarking techniques necessary for regulators to make greater use of productivity-based approaches to setting access prices.”⁷

16 The advantage of using external measures of productivity to set the technology factor is that such measures provide “powerful incentives for firms to improve their performance.”⁸ This advantage of using external measures of productivity, rather than firm-specific measures, is addressed by King and Maddock in their discussion of CPI-X pricing:

“Price cap regulation was initially hailed as a radical departure from regulatory processes based on observed profits. While there are important differences between ROR and price cap regulation, in practice the two regimes appear to have similar consequences. However, this similarity is due to inappropriate reliance on firm costs and profits in reviewing the value of X. A review process based on yardstick comparisons and other data that is not specific to the regulated firm may offer significant advantages.”⁹

17 The Productivity Commission suggests several external measures of productivity that may be relevant to the technology factor. These include Total Factor Productivity, measurements derived from Data Envelopment Analysis and measurements obtained through best practice benchmarking.

⁷ Productivity Commission “Review of the National Access Regime”, Report No. 17, September 2001, page 351.

⁸ Productivity Commission “Review of the National Access Regime”, Report No. 17, September 2001, page 344.

⁹ See King and Maddock, “Unlocking the Infrastructure”, 1996, Allen and Unwin: Sydney, p 63. The tendency for incentive-based regulation employing an adjustment factor determined on the basis of firm-specific measures to resemble rate of return regulation has been recognised by the Productivity Commission and by Laffont and Tirole. See: Productivity Commission “Review of the National Access Regime”, Report No. 17, September 2001, page 343; Laffont and Tirole, “Competition in Telecommunications”, 2000, MIT Press: Cambridge, page 86. The

18 AAPT supports the use of best practice benchmarking in calculating the technology factor. This approach will provide Telstra with strong incentives to perform in a manner which is consistent with best practice and is, therefore, consistent with the forward-looking nature of the telecommunications access regime. This approach will also ensure that access prices are adjusted over time in a manner reflecting the productivity improvements that would be achieved by an access provider operating consistently with best practice.

19 Further, the World Bank has pointed out the relevance of international benchmarking in cases where past performance is not a good indicator of future performance:

“In some instances, past productivity performance may not be a good indicator of future performance. This may be the case where the sector was not price regulated, was not operated efficiently or is the subject to very significant structural change.

In these circumstances, or when the operator and/or its operating environment are undergoing drastic change, the X-factor may have to be developed based on the informed judgement of the regulator and its advisors. International experience with price cap regulation can provide a useful benchmark in such cases. This is why we refer to this method as regulatory benchmarking.”¹⁰

20 There is evidence to suggest that this is the case for Telstra. In particular, Telstra’s past performance is not a good indicator of its future performance because Telstra has not operated efficiently. According to the Commission:

“The benchmarking results suggest that, on a whole-of-Telstra basis, there is considerable scope for Telstra to catch up with the productivity levels of carriers in other countries. For example, the Commission’s estimates suggest Telstra’s TFP would have to grow at 10.8 per cent per annum for three years just to catch up with Canada’s present TFP level.”¹¹

Given this, it is more appropriate to calculate the technology factor based on international benchmarking than to do so on the basis of Telstra’s past, inefficient, productivity performance.

Output Factor

21 The forward-looking nature of the regime is also relevant to the determination of the output factor.

failure of rate of return regulation to provide adequate incentives to the regulated firm, and the tendency for rate of return regulation to lead to “gold plating” and cost padding, has been well-documented.

¹⁰ World Bank, “Telecommunications Regulation Handbook”, November 2000, pages 4-22.

¹¹ ACCC, “Review of Price Control Arrangements”, February 2001, page 83.

- 22 AAPT submits that the output factor should be set according to the forward-looking expected output growth of an *efficient* access provider. Setting the output factor on this basis will provide Telstra with incentives to expand output in an efficient manner; it will also ensure that access prices are adjusted over time in a manner reflecting efficient growth in output.
- 23 In contrast, to base the output factor on output changes specific to Telstra reduces Telstra's incentive to increase output in an efficient manner. It also creates a situation in which the access prices will be greater the less efficient is Telstra's expansion of output – in other words, access seekers will be required to pay greater access prices the less competitively Telstra behaves.

ADC adjustment factor

- 24 AAPT refers to its previous submissions in relation to the ADC.¹²
- 25 AAPT will also be providing its views in relation to the proposed ADC in its submissions on Telstra's undertakings.

Use of total factor productivity

In addition to the questions posed in the Commission's undertaking discussion paper identified above, the Commission is interested in the views of interested parties on what form of a TFP measure should be used for the purpose of calculating an adjustment factor.

- 26 In relation to the appropriate TFP measure to use in calculating an adjustment factor, AAPT reiterates the importance of setting adjustment factors which are consistent with the forward-looking nature of the telecommunications access regime and, in particular, which are consistent with the promotion of efficient behaviour on the part of access providers.
- 27 For Telstra to have appropriate incentives to improve the efficiency of its operations, it is necessary that the TFP measure used to calculate the adjustment factor captures all the improvements that it is reasonable to expect Telstra to make during the period covered by the undertakings or by the arbitration, whichever is relevant.
- 28 More particularly, AAPT submits that there is merit to the view that the appropriate TFP is the telecommunications industry TFP rather than a Telstra-specific or an asset-specific TFP. There are two reasons to support the use of a telecommunications industry TFP:

¹² Including its submission on the future access pricing in September 2002 and the Need for an ADC in February 2003.

- (a) as a matter of principle, a TFP narrower than the telecommunications TFP may fail to provide adequate incentives to Telstra. For instance, an industry specific TFP amounts to a measurement of the productivity improvements expected to be achieved by Telstra's operations. As a result, inefficiencies in Telstra's operations will be imbedded in the specific TFP. The result is that Telstra will have less incentive to improve the efficiency of its operations and retail costs will not be reduced in future periods by the full amount that efficiency considerations suggest is appropriate. A broader measure of TFP, on the contrary, is likely to be less susceptible to distortion by the inefficiency of particular assets. Consequently, a telecommunications industry TFP may provide a more appropriate measure; and
- (b) as a practical matter, the calculation of asset TFP's requires complex modelling which will be the subject of debate. The Commission would be required to model the likely future course of costs and outputs for the relevant asset, and to update this model on a regular basis. This can be expected to cause significant debate and delay. The calculation of a telecommunications industry TFP, on the other hand, is considerably less complex. Furthermore, the use of a telecommunications industry TFP affords a greater opportunity to test the appropriateness of the adjustment factor by referring to measures of telecommunications industry TFPs from other jurisdictions. Asset-specific TFP's, however, are unlikely to be comparable across jurisdictions.