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Pricing principles and indicative prices for local carriage service and wholesale line rental – a guide

April 2008

Contents

1. Introduction

Once a service is declared under Part XIC of the *Trade Practices Act 1974* (Act), the Australian Competition and Consumer Commission (Commission) has the following responsibilities:

- it may make a telecommunications access code, which sets out the model terms and conditions for access to declared services[1]
- it must accept or reject undertakings submitted by access providers,[2] and
- arbitrate disputes between parties concerning the terms and conditions of access to declared services.[3]

These tasks may involve approving or determining a price for the declared service, or a method for ascertaining a price.

The Commission is also required by section 152AQA of the Act to determine, in writing, principles relating to the price of access to declared services. The pricing principles determination may contain price-related terms and conditions (indicative prices) relating to access to the declared service. The Commission must make such a determination at the same time as, or as soon as practicable after, the Commission declares a service. The Commission is also required to publish a draft determination, invite submissions on the draft and consider any submissions received, before it makes a final pricing principles determination.

The Commission must have regard to its pricing principles determination if it is required to arbitrate an access dispute in relation to the same declared service.[4] However, the pricing principles are not binding on the Commission and parties to arbitrations are still able to address the Commission on the relevance and applicability of the principles having regard to the circumstance of their dispute. The Commission considers that, although a party may argue against the principles being applied to its particular case, pricing principles may help guide commercial negotiation of access by providing greater certainty as to the Commission's views on reasonable access prices.[5]

The purpose of this guide is to inform industry, government and other interested parties of the pricing principles and indicative prices that are likely to guide the Commission when considering an access dispute or assessing an undertaking in relation to pricing for access to declared services such as local carriage service (LCS) and wholesale line rental (WLR).

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1 Part XIC, Division 4 of the Act.

2 Part XIC, Division 5 of the Act.

3 Part XIC, Division 8, Subdivision C of the Act.

4 Section 152AQA(6) of the Act.

5 See *Trade Practices Amendment (Telecommunications) Bill 2001*, pp. 10, 18.

Background

In July 1997, the Commission published *Access Pricing Principles: Telecommunications — a Guide* (*Access Pricing Principles*). The purpose of the *Access Pricing Principles* was to advise the telecommunications industry and other interested parties about the principles that are likely to be relevant in assessing undertakings or in arbitrating access disputes. It set out the following broad principles:

- the access price should be based on the cost of providing the service
- the access price should not discriminate in a way which reduces efficient competition
- the access price should not be inflated to reduce competition in dependent markets, and
- the access price should not be predatory.

In the *Access Pricing Principles*, the Commission noted that when determining a cost-based price, it would generally seek to determine the Total Service Long-Run Incremental Cost (TSLRIC) of providing the service. However, it also noted that the applicable approach would be assessed on a case-by-case basis for each service.

In April 2002, the Commission released pricing principles and indicative prices for LCS because it considered the TSLRIC methodology was not appropriate for this service at that stage. The Commission indicated it would be likely to adopt a retail-minus methodology to determine an access price in the event of an LCS access dispute or when assessing an LCS undertaking. The retail-minus methodology determines the LCS price by subtracting retail costs from the retail price of a local call.

In October 2003, the Commission released its *Final Determination for Model Price Terms and Conditions of the PSTN, ULLS and LCS services*. The Commission specified retail–minus access prices for LCS for 2003-2004 and 2004-2005, because of the pending review of the LCS declaration and pricing principles.[6]

In 2006 the Commission conducted the *Local Services Review*, which considered the declaration of LCS and WLR.[7] On 28 July 2006, the ACCC released the *Local services review—final decision* in which the Commission decided to continue the declaration of the LCS for a period of three years, and to declare the WLR service for three years. At the same time the ACCC published the draft pricing principles determination and indicative prices for both services for consultation.[8]

In November 2006, the ACCC released the final pricing principles determination and indicative prices for LCS and WLR relevant for the period 2006-2007 (*2006 Pricing Principles Determination*).[9] In the *2006 Pricing Principles Determination* the Commission stated that a

6 ACCC, *Final Determination —Model Non-price Terms and Conditions,* October 2003.

7 ACCC, *Local services review—final decision*, July 2006.

8 ibid., p.7.

9 ACCC, *Pricing principles and indicative prices: local carriage service, wholesale line rental and PSTN originating and terminating access service- Final Determination and Explanatory Statement,* 29 November 2006, (2006 Pricing Principles Determination).

retail-minus-retail-cost (RMRC) approach should be adopted until such time as a robust cost model is available.[10] The Commission also proposed indicative prices based on the RMRC approach for both services for the 2006-2007 period. The final 2006-2007 indicative prices for LCS and WLR are set out in the tables below:

Final indicative prices for LCS 2006-2007[11]

	Local Calls
Telstra Retail Prices	20c ex GST
Unit Avoidable Retail Costs	2.29c/call
GST Adjustment	0.21c
Indicative Price	17.92c

Final indicative prices for WLR 2006-2007[12]

	HomeLine Part	**BusinessLine Part**
Telstra Retail Prices	$29.05	$31.77
Unit Avoidable Retail Costs	$5.93/mth	$5.93/mth
Indicative Price	$23.12	$25.84

Following the *2006 Pricing Principles Determination,* the ACCC commenced development of a fixed network cost model. The ACCC's development of the fixed network cost model is ongoing and the model has not yet been finalised. Without a robust cost model available to it at this time, the Commission proposes to issue draft pricing principles and indicative prices for the period 2008-2009, which is consistent with the RMRC approach enunciated in the *2006 Pricing Principles Determination*. The Commission considers that the indicative prices for the LCS and WLR for 2008-2009 will be transitional in nature and will stay in place while the ACCC completes its development of the fixed network cost model.

Timetable and submissions

The ACCC encourages industry participants, other stakeholders and the public more generally to consider the pricing principles for the declared services set out in this guide, and make submissions to the Commission by **5pm on Wednesday 14 May 2008**.

All submissions will be considered as public submissions and will be posted on the Commission's website. If parties wish to submit commercial-in-confidence material as part of their submission to the Commission, parties should submit both a public and commercial-in-confidence version of their submission. The public version of the submission should clearly identify the commercial-in-confidence material by replacing the confidential material with an appropriate symbol or 'c-i-c'.

10 ACCC, *2006 Pricing Principles Determination*, Appendix B.

11 ACCC, *Pricing principles and indicative prices: local carriage service, wholesale line rental and PSTN originating and terminating access service- Final Determination and Explanatory Statement,* 29 November 2006, p. 12.

12 ibid., p.12.

Submissions are to be sent by email, in Microsoft word document form to:

Contact Officer:

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2. The relevant legislative criteria

The object of Part XIC of the Act is to promote the long-term interests of end-users (LTIE) of carriage services, or of services provided by means of carriage services.[13] This will be achieved, in part, through establishing the rights of third parties to gain access to services that are necessary for the competitive supply of services to end-users.

An important part of the access regime is the terms and conditions of access (including the price or a method for ascertaining the price). Under Part XIC of the Act the Commission cannot make a telecommunications access code or accept an undertaking unless satisfied that the terms and conditions specified are reasonable.[14] In determining whether terms and conditions are reasonable, regard must be had to the following matters:

- whether the terms and conditions promote the LTIE
- the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or carriage service provider's investment in facilities used to supply the declared service concerned
- the interests of persons who have rights to use the declared service concerned
- the direct costs of providing access to the declared service concerned
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility, and
- the economically efficient operation of a carriage service, a telecommunications network or a facility.[15]

This does not, by implication, limit the matters to which regard may be had.[16]

When arbitrating access disputes the Commission must have regard to the same matters. In addition, when making a determination, the Commission must take into account the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else.[17]

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13 Sub-section 152AB(1) of the Act.

14 The Commission must also ensure that the terms and conditions in the TAF access code, in undertakings and any arbitration determination is consistent with any Ministerial pricing determination in place. See section 152CH of the Act.

15 Sub-section 152AH(1) of the Act.

16 Sub-section 152AH(2) of the Act.

17 Paragraph 152CR(1)(e) of the Act.

3. Pricing principles

Introduction

As outlined in the *Local Service Review,*[18] the ACCC considers that there are two main pricing principles for pricing the declared services—the RMRC approach and the cost-based approach.

RMRC is a 'top-down' approach that takes the retail prices paid for the declared service and deducts the avoidable costs of retailing the service to end-users to calculate an access price. A cost-based approach, in comparison, is a 'bottom-up' approach that models the costs of the various network elements necessary for use in the service (and also, typically, allocates common costs).[19] Where the retail service and wholesale service are the same product, and where retail prices are strictly cost-based, the two pricing approaches will lead to (approximately) the same access price.

However, the approaches will more often lead to divergent access prices. Of particular relevance are the following two scenarios:

- If retail prices are held below costs (which may be the case due to the government's retail price control regime), a RMRC approach will lead to lower access prices than a cost-based approach.

- If retail prices are above total (wholesale + retail) costs, then the access seeker is making some level of economic profit. An RMRC price will be higher than cost-based prices because it will reflect this level of economic profit. The access provider would accordingly retain these profits from the RMRC price at the expense of access seekers and/or access seekers' end-user customers. A cost-based approach would not preserve this profit.

The relative levels of price and cost is a crucial factor in determining whether a RMRC or cost-based pricing approach is the most appropriate under the statutory criteria in the Act.

Total Service Long-Run Incremental Costs

The TSLRIC+ approach can be best considered by breaking the concept into the following components:

- 'Total service' refers to the cost of production of an entire service, not to the cost of a particular unit. However, the cost is usually expressed on a per-unit basis by dividing total costs for the service by the number of units supplied.
- 'Long run' refers to a period where all factors of production can be varied, as opposed to the short run, where the amount of at least one factor of production is fixed.

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[18] ACCC, *Local Services Review— final decision,* July 2006.

[19] The ACCC has typically chosen to apply the Total Service Long Run Incremental Cost (TSLRIC) approach when applying a cost-based pricing methodology.

- 'Incremental costs' refers to the additional costs of supplying the service over and above the situation where the service was not supplied, assuming that the scale of all other production activities remains unchanged. Strictly speaking, the concept refers to only those costs that can be attributed to the production of the service. In practice, the strict TSLRIC concept is often expended to include a contribution for indirect and overhead costs (TSLRIC+).

The TSLRIC methodology

TSLRIC measures the incremental or additional cost the firm incurs in the long term in providing the service, assuming all of its other production activities remain unchanged.

TSLRIC represents an estimate of the costs that an efficient firm would incur in providing the service over the long run. As mentioned, these costs can be specific to the particular service or additionally include costs that are 'common' to a range of services (i.e. TSLRIC+). Common costs are the costs incurred in the provision of a group of services, which are not avoided unless the production of all services ceases.

To estimate costs, a forward looking approach is adopted. Given that TSLRIC is a long-run cost measure, the time horizon is sufficient so that all necessary investments can be replaced. Thus, the cost of efficient forward-looking investment in long-lived assets required to produce network services is included in TSLRIC+, even if some or all of the investment will become sunk once in place.

The Commission has used TSLRIC-based pricing to price other declared services (e.g. the Domestic Public Switched Telephone Network Originating and Terminating Access (PSTN OTA) services). In general, it considers such pricing to be appropriate for services:

- that are well developed
- that are necessary for competition in dependent markets, and
- where the forces of competition or the threat of competition work poorly in constraining prices to efficient levels.[20]

According to the *Access Pricing Principles*, an access price based on TSLRIC would be consistent with the price that would prevail if the access provider faced effective competition, and would usually best promote the LTIE. A TSLRIC-based access price would:

- promote efficient entry and exit in dependent markets since prices are based on long-term costs
- encourage economically efficient investment in infrastructure by providing for a normal commercial return on efficient investments in infrastructure
- provide for the efficient use of infrastructure, as access prices are based on the long-term value of the resources embodied in that service

[20] ACCC, *Access Pricing Principles: Telecommunications – a Guide*, 1997, pp. 27-28.

- provide incentives for access providers to minimise the costs of providing access by using best-in-use technology compatible with existing network design to measure cost
- allow efficient access providers to fully recover the costs of producing the service, and promote the legitimate business interests of the access provider, and
- inhibit the access provider discriminating in favour of one access seeker over another (unless the discrimination is based on differences in costs).[21]

Retail-minus methodology (RMRC)

Under a retail-minus methodology, the access price is determined by deducting the access provider's retail costs from the retail price for a given service.

This methodology has been expressed in a number of ways. Sometimes, it is expressed as 'retail-minus avoidable costs' and in other instances as simply 'avoidable costs'. Avoidable costs are regarded as costs that an access provider would avoid, or can avoid, if it ceased provision of retail activities completely in respect of the service in question (e.g. local calls).

On some occasions, a distinction is also made between avoidable costs and avoided costs. Avoidable costs are the costs that an access provider could avoid if it ceased retail operations completely, whereas avoided costs are those costs that the access seeker *actually* avoids when it ceases retailing to the end-users who are now supplied by its competitor.

Telstra, in an earlier submission, stated:

> …the avoidable cost standard sets a wholesale discount by reference to assumed costs which would be saved by an access provider if it ceased retailing altogether, whereas in the real world Telstra supplies local calls for resale in circumstances where it will, regardless of whether resellers purchase service from it for resale, incur significant fixed costs. [22]

What is sought to be measured, however, is not so much the quantum of costs that the access provider could conceivably avoid through its supply of wholesale services, but rather the average retail cost of supplying a particular service (e.g. local calls). In this regard, the definition of avoidable costs provides a means of identifying and estimating retail costs. That said, the Commission acknowledges that the terminology 'avoidable costs' is capable of creating the impression that the access provider can avoid those costs, when in reality this may not occur. Consequently, the Commission has chosen to express the methodology as 'retail-minus-retail-costs'.

Finally, the Commission notes that, in a competitive market in the absence of retail price regulation, the retail-minus price and TSLRIC-based price should converge.

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[21] ibid., pp. 29-30.

[22] Telstra, Submission 1 September 2000, as quoted in ACCC, *Local Carriage Service pricing principles and indicative prices Final Report (Revised),* April 2002, p.11.

4. Pricing Principles for LCS and WLR

Pricing Principles for LCS and WLR

This section explains the Commission's proposed pricing principles determination for the LCS and WLR services (together the 'declared services'). The ACCC invites interested parties to provide submissions on the draft pricing principles determination and indicative prices relevant for the 2008-2009 period.

Section 152AQA(2) of the Act outlines that a pricing principles determination made by the Commission may also contain price-related terms and conditions relating to access to the declared service.

The Commission's pricing principles

The pricing principles established in the previous review noted that a RMRC principle should be maintained as an interim pricing approach.[23]

The ACCC previously noted that the decision between a RMRC pricing principle and a cost-based pricing principle was not clear-cut. In particular, the choice between the two principles depended significantly on the relativity between retail prices for the local call and line rental products and the cost of providing the LCS and WLR products.

In particular the ACCC noted:

- if costs are below the RMRC access price for the service, then a cost-based approach would be more likely to be reasonable, and
- if RMRC access prices are below costs, then a RMRC approach would be more likely to be reasonable.

The ACCC considers that no definitive view can be made on which pricing principle to adopt, but notes that in the absence of a robust cost model capable of producing reliable estimates of costs in all geographic regions, it would be difficult to conclude that cost-based pricing should be adopted.

The ACCC considers that once it has developed a fixed network cost model capable of producing reliable cost estimates in all geographic regions, it should seek to implement a cost-based pricing approach. While the choice between RMRC and cost based pricing approaches is closely balanced on an assessment of the statutory criteria, the ACCC notes that the evidence presented to the previous declaration review suggested that retail prices and RMRC access prices currently exceed cost-based prices, particularly for WLR.

23 ACCC, *Local Services Review— final decision,* July 2006, p. 58.

The ACCC also considers that moving towards a future implementation of a cost-based pricing approach is appropriate for the following reasons:

- greater consistency with pricing of other access services
- widespread industry support for a cost-based model
- greater relevance for the pending development of the cost model, and
- certainty for industry about future pricing.

The Commission's view is therefore to continue to adopt an interim RMRC pricing approach for the 2008-2009 period, consistent with the *2006 Pricing Principles Determination*. The Commission will seek to implement a cost-based pricing approach for the declared services once its fixed network cost model is complete.

5. Indicative prices for LCS and WLR

In the Commission's view, the indicative prices which should apply for WLR and LCS for the 2008-2009 period are shown in Table 1[24].

Table 1: Indicative prices for WLR and LCS for 2008-2009

	Residential	**Business**
WLR	$27.58 ex GST	$25.90 ex GST
LCS	17.96c ex GST	17.96c ex GST

Both indicative prices and model price terms and conditions are designed to provide guidance to access providers and access seekers involved in negotiating the terms and conditions of access to services, particularly as they would be taken into account by the ACCC in any arbitration of access disputes. They can also act as a guide to parties considering providing access undertakings to the ACCC for particular services.

Indicative prices provide this guidance by giving parties an idea of the ACCC's views on the appropriate pricing for the declared service.

However the ACCC notes that indicative access prices set out in a determination are non-binding on parties to arbitrations or undertaking assessments. While the ACCC would ordinarily see these access prices as appropriate in a general sense, it must look at specific issues raised by the parties in particular arbitrations or undertakings, on their individual merits. As such, there will remain potential for an arbitration determination or an approved undertaking to depart from the indicative prices.

In applying the RMRC methodology, it is necessary to deduct avoidable retail costs of line rental and local calls from retail prices to obtain the RMRC prices for the LCS and WLR. The ACCC has derived estimates of Telstra's average avoidable retail costs for these two services from retail and wholesale cost information contained in Telstra's Regulatory Accounting Framework (RAF) accounts for the first half of 2007-2008.

24 ACCC, *Local Services Review— final decision,* July 2006, p. 83.

Telstra's avoidable costs for the first half of 2007-2008 for end-user access and local calls are shown in Table 2.

Table 2: Telstra's avoidable retail costs and volumes for end-user access and local calls, first half of 2007-2008 RAF

	End-User Access	Local Calls
4-1 Organisational ($m)	**[c-i-c]**	**[c-i-c]**
4-2 Product and Customer ($m)	**[c-i-c]**	**[c-i-c]**
Cost of Capital ($m)	**[c-i-c]**	**[c-i-c]**
Total Retail Costs ($m)	**[c-i-c]**	**[c-i-c]**
Volume (m)	**[c-i-c]**	**[c-i-c]**
Unit avoidable retail costs for line rental and local calls	**$5.87/mth**	**2.24c/call**

As noted by Frontier Economics[25] in producing model terms and conditions for the LCS in 2003, the Commission made a number of adjustments to the retail costs from Telstra's RAF data. This was intended to provide a better representation of Telstra's avoidable retail costs. These adjustments were not included in indicative prices relevant for the 2006-2007 period and have not been included in the proposed indicative prices relevant for the 2008-2009 period.

In making the decision not to include these adjustments, the ACCC wishes to note that in the Model Price Terms and Conditions of October 2003, the ACCC quite clearly expressed its reservation regarding the arbitrary nature of these adjustments.[26] Secondly, in assessing whether these adjustments meet the LTIE, the Commission needs to balance the fact that an RMRC-based pricing approach may on the one hand encourage the building of infrastructure, but on the other it may act as a deterrent to facilities-based competition if it prevents access seekers developing sufficient scale to justify establishing their own facilities.[27] Thirdly, the ACCC has noted its preference for a cost-based pricing approach for LCS and WLR.[28]

[25] Frontier Economics, *Indicative prices for wholesale line rental and local call services.* A report prepared for the Competitive Carriers Coalition, August 2006.

[26] ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services,* October 2003.

[27] ibid., pp 67-68.

[28] ibid., p. 75.

The charges for LCS and WLR are set out below in Tables 3 and 4 respectively; and in Part 2 of Schedules 1 and 2 to the instrument at Appendix 1.

Table 3: Indicative prices for LCS 2008 and 2009

	Local Calls
Telstra Retail Prices	20c ex GST
Unit Avoidable Retail Costs	2.24c/call
GST Adjustment	0.20c
Indicative Price	17.96c c

Table 4: Indicative prices for WLR 2008 and 2009

	HomeLine Part	**BusinessLine Part**
Telstra Retail Prices	$33.45[29]	$31.77[30]
Unit Avoidable Retail Costs	$5.87/mth	$5.87/mth
Indicative Price	$27.58	$25.90

29 Telstra, *Our Customer Terms*, 11 January 2008. Accessed 2 April 2008, http://www.telstra.com.au/customerterms/docs/hf_fixed_homeline.pdf, p. 20.

30 Telstra, *Our Customer Terms*, 13 February 2008. Accessed 2 April 2008, http://www.telstra.com.au/customerterms/docs/bg_fixed_bps.pdf, p. 43.

Appendix 1.

TRADE PRACTICES ACT 1974

Section 152AQA

Pricing principles for the Local Carriage Service & Wholesale Line Rental Services

The Australian Competition and Consumer Commission determines, pursuant to section 152AQA of the *Trade Practices Act 1974* (Act), that the pricing principles and price-related terms and conditions specified in the Schedules are to apply to the following services declared by the Commission under section 152AL of the Act:

(a) the Local Carriage Service

(b) the Wholesale Line Rental Service

Note: For the effect of this determination, see subsection 152AQA(6) of the Act.

Made by the Australian Competition
and Consumer Commission on
<day><month> 2008

Graeme Samuel
Chairman

SCHEDULE 1 – Local Carriage Service (LCS)

Part 1 – Pricing Principles

An interim retail-minus-retail-costs (RMRC) pricing principle should be adopted until such time as the Commission has a robust cost model available. In implementing the interim RMRC pricing principle, the Commission will use:

- avoidable retail costs for the LCS rather than avoided retail costs
- unbundled benchmark retail prices, and
- separate pricing of the LCS.

The Commission will seek to implement a cost-based pricing approach once a robust cost model, capable of producing reliable estimates of costs in all geographic regions, is available.

Part 2 – Price-related terms and conditions

	Local Calls
Telstra Retail Prices	20c ex GST
Unit Avoidable Retail Costs	2.24c/call
GST Adjustment	0.20c
Indicative Price	17.96c

SCHEDULE 2 – Wholesale Line Rental Service (WLR)

Part 1 – Pricing Principles

An interim retail-minus-retail-costs (RMRC) pricing principle should be adopted until such time as the Commission has a robust cost model available. In implementing the interim RMRC pricing principle, the Commission will use:

- avoidable retail costs for the WLR rather than avoided retail costs
- unbundled benchmark retail prices, and
- separate pricing of the WLR.

The Commission will seek to implement a cost-based pricing approach once a robust cost model, capable of producing reliable estimates of costs in all geographic regions, is available.

Part 2 – Price-related terms and conditions

	HomeLine Part	**BusinessLine Part**
Telstra Retail Prices	$33.45[31]	$31.77[32]
Unit Avoidable Retail Costs	$5.87/mth	$5.87/mth
Indicative Price	$27.58	$25.90

31 Telstra Corporation Limited, *Our Customer Terms*, 11 January 2008, Accessed 2 April 2008, http://www.telstra.com.au/customerterms/docs/hf_fixed_homeline.pdf, p. 20.

32 Telstra Corporation Limited, Our *Customer Terms*, 13 February 2008, Accessed 2 April 2008, http://www.telstra.com.au/customerterms/docs/bg_fixed_bps.pdf, p. 43.