Australian
Competition &
Consumer
Commission

LSS Access Dispute

Telstra / Adam Internet

Reasons for Final Determination

December 2007

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Executive Summary

The Commission has determined a number of terms regarding Telstra's supply of the Line Sharing Service ('LSS') to Adam Internet (Adam'). These terms include LSS annual charges and the connection and disconnection of LSS services, either individually or as part of a 'network migration'. This determination has been made as a result of the parties being unable to agree on these terms, and Adam notifying the Commission that an access dispute existed which required the Commission's arbitration.

The Commission has specified a LSS annual charge of $2.50 per LSS service per month and has reduced the charges that currently apply when connecting or disconnecting a LSS. The specified charges have been backdated. The LSS annual charges apply from 14 July 2006 until 31 July 2009.

The charges result from applying the Commission's pricing principles for the LSS and, in respect of LSS annual charges, the ruling of the Australian Competition Tribunal.[1]

Telstra proposed in previous regulatory proceedings an LSS annual charge of $9 per service per month, which was opposed by access seekers, and considered not to be reasonable by both the Commission (December 2005) and the Australian Competition Tribunal (June 2006). Following these rulings, Telstra continued to require access seekers to pay a $9 per month charge.

A key issue in this arbitration was whether the LSS annual charge payable by Adam for the period of the determination should contribute to the costs of the line over which the LSS is supplied. The Commission has decided against this requirement. This is because the Commission has for some time recognised that economic efficiency can be enhanced by the inclusion of an appropriate contribution to line costs in LSS annual charges. However, where line costs are fully recovered in other charges, the inclusion of such a contribution in LSS annual charges would lead to an over-recovery of costs. In these circumstances, reductions in charges for other network services, such as wholesale line rental, are needed in order to avoid any such 'double dipping'

Rebalancing charges in this way may take time, has the potential to disrupt competition in DSL services if done too quickly, and is dependent upon Telstra restructuring its existing charges for other services.

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[1] *Telstra Corporation Limited* [2006] ACompT 4 (2 June 2006)

1. Introduction

1.1 Purpose

1. Adam and Telstra have been in dispute over certain terms of access to the LSS. This dispute was notified to the Commission for arbitration, and the Commission has made a final determination. This document sets out the reasons for making this final determination.

1.2 Background to arbitration and final determination

2. The Commission received Adam's dispute notification on 15 November 2006 (notification dated 14 November 2006).

3. The Commission considered written submissions from the parties on preliminary matters, and advised its views on these matters on 5 March 2007, and shortly afterwards commenced consultation towards making a final determination.

4. The parties remained unable to resolve the dispute, and raised the following terms of access for consideration in the final determination:

    1. LSS Annual charges
    2. Charges for LSS 'single' connections and disconnections
    3. Terms and conditions relating to Managed Network Migrations (MNM) as follows:
        - (a) LSS Connection charges for MNMs involving 50 or more services
        - (b) Minimum number of LSS connections as a precondition for requesting a MNM
        - (c) Minimum MNM charge per exchange

1.3 Consultation Process

5. On 20 April 2007, the Commission commenced consultation on the making of a final determination.

6. On several occasions the Commission sought the parties' submissions on various procedural matters (20 April 2007, 4 May 2007, 29 May 2007 and 13 July 2007). Submissions from parties were received on 26 April 2007, 18 & 25 May 2007, 12 & 14 June 2007 and 20 July 2007. The Commission provided its views to parties on the procedural matters on 8 June 2007, 13 July 2007 and 8 August 2007.

7. Other access disputes had been notified in respect of the LSS, and there was overlap in the terms of access that were disputed. After seeking the parties' views, the Commission held a joint hearing to consider the terms of access that were commonly disputed in four LSS access disputes (Adam/Telstra, Agile/Telstra, Amcom/Telstra and Primus/Telstra). This was done as it was considered that holding a joint hearing on these matters was likely to result in the disputes being resolved in a more efficient and timely manner. And so, these reasons for decision on occasion refer to submissions that were advanced in common by Adam, Agile, Amcom and Primus ('AAAP') in the joint hearing. Terms of access that were disputed in only a single arbitration were dealt with in a separate hearing. That hearing only involved the parties to that arbitration.

8. The Commission provided to the parties a draft final determination, and an accompanying consultation paper on the common issue of annual charges to assist the parties in providing their submissions, on 16 August 2007. The draft final determination reflected the Commission's preliminary views pending consideration of the parties' submissions. The Commission provided a supplementary consultation paper on LSS 'single' connection, 'single' disconnection and MNM terms to Adam and Telstra only, on 31 August 2007.

9. Following a request from Telstra, the timetable for parties' submissions was extended. Parties provided detailed written submissions on 20 September 2007 (for principal submissions) and 1 October 2007 (for response submissions). In addition to its submissions and primary attachments, Telstra also provided on 21 September 2007 three CD-Roms containing annexures to its submissions (comprising 10.2 MB of data); copies of its PIEII cost model (1.26 GB of data); and other documents accompanying Telstra's submissions (505 MB of data). Amongst other things, the CR-Rom of supporting material included a cost model that Telstra proposed in respect of LSS 'specific-costs'. Telstra provided a further CD-Rom on about 2 October 2007 containing supporting documents to Telstra's reply submission (comprising 4.66 MB of data).

10. Telstra and access seekers subsequently made further submissions. Telstra made confidentiality requests over some of the information it submitted in its initial submissions claiming it should not be provided to the access seekers [Telstra letter, 20/9]. The Commission consulted with access seekers [Commission letter, 27/9; AAAP letter, 4/10] and then Telstra [Commission letter, 12/10; Telstra letter 18/10] in accordance with section 152DK of the *Trade Practices Act 1974* (the Act).

11. In addition, Telstra asked the Commission to exercise its powers under sections 152DB, 152DBA and 152DC in relation to confidential information submitted by Adam. Telstra requested that the Commission use its powers to have regard to this information in the other disputes in this joint hearing [Telstra, letter, 12/10].

12. Telstra submitted an additional report on 26 October 2007, titled "Access Regulation and Infrastructure Investment in the Telecommunications Sector: an Empirical Investigation" by LECG Ltd, dated September 2007 and requested that the Commission have regard to this report.

13. On 29 October 2007, the Commission published its decision regarding the declaration of the LSS and appropriate pricing principles for it. The decision was to extend the declaration to 31 July 2009. The access seekers made further submissions about the appropriate expiry date for the final determination in light of this decision. [AAAP letter, 30/10].

14. On 6 November 2007, Telstra submitted that the Commission should have regard to a range of US cases in support of its arguments relating to averaged ULLS and LSS prices and consistency regarding averaging and de-averaging of prices between wholesale and retail prices [Telstra, 6/11, pp. 1-3].

15. On 7 November 2007, the Commission wrote to parties to:

  - advise of its decision in relation to Telstra's section 152DK requests;
  - advise of its decision in relation to a Telstra request for the Commission to have regard to Adam's confidential information in arbitrating other disputes; and
  - seek final submissions on particular matters discussed in a supplementary consultation paper, namely:
    - Telstra's ADSL services in Band 4;
    - the extension of the LSS declaration, the LSS pricing principles and indicative prices;

- Telstra's claimed Current Cost Accounting (CCA) costs; and
- Telstra's ability to recover its line costs.

16. The access seekers submitted, on 12 November 2007, that the Commission should not have regard to the submissions Telstra made on 6 November 2007 regarding US cases.

17. Telstra provided further correspondence on 12 November 2007 regarding submissions made in the High Court proceedings.

18. On 15 November 2007 submissions from parties were received in response to the Commission's Direction and supplementary consultation paper of 7 November 2007.

19. Telstra responded, on 19 November 2007, to previous access seeker correspondence and, on 20 November 2007, to the Commission's advice that it would not have regard to the confidential Adam information in arbitrating other disputes. The Commission declined to do so, as it did not consider the material to be relevant to the other access disputes.

20. Telstra wrote to the Commission on 19 December 2007 seeking confirmation as to whether the Commission would interpret the statutory criteria consistently with how it proposed in the consultation paper, and whether it would consult the parties on matters relating to 'just terms'. The Commission has considered this submission and does not consider that further consultation or submissions are required.

21. Telstra again wrote to the Commission on 19 December 2007 to reiterate its previously expressed view that different terms of access should be set for LSS supplied within the footprint of the Optus Hybrid Fibre Coaxial (HFC) network. Telstra enclosed a submission dated 17 December 2007 relating to an application Telstra had made for an exemption from standard access obligations relating to the ULLS, and statements from Michael G Harris and Professor Martin Cave.

2. Preliminary Matters

2.1 The Line Sharing Service

22. The LSS involves access to the higher frequency spectrum of a line (metallic pair) on which a PSTN voice service is being supplied. It typically allows two carriers to provide separate services over a single line. Access to the higher frequency spectrum is generally used to supply broadband (DSL) services, while the PSTN voice service is supplied over the lower frequency spectrum.

23. The LSS is a declared service. The Commission declared the LSS on 30 August 2002, pursuant to subsection 152AL(3) of the Act. A copy of the declaration was published in the *Commonwealth of Australia Gazette* No. GN41, 16 October 2002.

24. After holding a public inquiry the Commission decided to extend the declaration of the LSS to 31 July 2009. The reasons for this decision are contained in ACCC, *Review of the Line Sharing Service Declaration – Final decision*, October 2007. A copy of the extension notice was published in the *Commonwealth of Australia Special Gazette No. S214*, 29 October 2007.

2.2 Access obligations and existence of dispute relating to access

25. The Commission sought the parties' views on whether access obligations are owed and whether a dispute exists in relation to access.

26. Access Seekers are of the view that access obligations are owed, and that an access dispute exists. [AAAP 20/9, Part 1, p.2]

27. Telstra accepts that a dispute exists between it and Adam [Telstra, 20/9, Pt 2, p. 5].

28. The Commission has formed the view that, with respect to the access dispute, the requirements of subsection 152CM(1) of the Act are satisfied. That is:

- Telstra is a carrier;
- Telstra supplies the declared LSS;
- Telstra has an obligation under subsection 152AR(3) of the Act to supply the LSS to the access seeker; and
- the access seeker is unable to agree with Telstra about the terms and conditions of access to the LSS addressed in the final determination.

2.3 Whether the Commission has jurisdiction to arbitrate the access dispute

29. Although Telstra accepts that an access dispute exists between Adam and Telstra, it disputes that the Commission has jurisdiction to conduct the arbitration and reiterates that its participation in the arbitration should not be taken as a concession that the Commission has jurisdiction. Telstra reiterates its earlier concerns that Part XIC of the Act is invalid, therefore the Commission does not have jurisdiction to arbitrate the dispute. Telstra also contends that the LSS Declaration is a legislative instrument (under the *Legislative Instruments Act 2003*) but because it has not been registered it ceases to be enforceable and should be taken to have been repealed, therefore any final determination made in the dispute would be invalid and unenforceable. [Telstra 20/9, Pt 2, pp. 5-6]

30. Telstra has also submitted that Adam's dispute notification is invalid because:

- Adam has not complied with the contractual dispute resolution requirements set out in the Customer Relationship Agreement (CRA); and
- The notification is not in a form in accordance with Regulation 28T (of the *Trade Practices Regulations 1974*) as it did not set out the matters on which the parties agree. [Telstra, 1 Feb 2007, pp. 2-4]

31. The Access Seekers submit that the Commission is obliged to consider Part XIC is validly enacted unless the High Court has determined otherwise. Access Seekers disagree with Telstra's claim that the LSS declaration has been repealed due to its non-registration under the Legislative Instruments Act [AAAP, 1/10, Part 1, p. 1]

32. Regulation 28T of *Trade Practices Regulations 1974* ('the Regulations') specifies certain requirements as to the form of a notification. The Commission advised the parties that it was satisfied that the form of the notification was appropriate. In this regard, the Commission considered that Adam had satisfied each of the formal requirements in full, or substantially satisfied them. In any event, a failure to comply with the Regulations does not prevent the arbitration continuing, unless the Commission made a direction that it should not continue [subregulation 26(1) of the Regulations]. In this regard, the Commission advised the parties that in its view the nature and scope of the dispute was clear, and that the Commission would proceed on the basis that the Regulations were complied with and would not have to proceed under subregulation 26(1).

33. The Commission has also previously rejected Telstra's request to suspend the arbitration because of Telstra's High Court proceedings regarding the validity of Part XIC. The Commission considered that it was entitled to proceed on the basis that the legislation is validly enacted. The Commission continues to hold this view.

34. The Commission is also of the view that the LSS Declaration is not a legislative instrument for the purposes of the *Legislative Instruments Act 2003*, and therefore does not need to be registered in accordance with that Act. Accordingly, the Commission does not consider that the LSS declaration should be taken to have been repealed.

35. The Commission is satisfied that the parties were unable to agree on the disputed terms. The Commission considers that an access seeker is not required by the Act to pursue a contractual dispute resolution process (where such a procedure is available) before being able to validly notify a dispute to the Commission.

2.4 Whether to proceed to make a final determination

36. Telstra submits that the Commission should not at this time make a final determination in the arbitration, and should instead await the decisions in the LSS judicial review proceedings Telstra has commenced regarding other final determinations that the Commission has made in respect of access to the LSS. [Telstra, 20/9 Pt 2, p 6]

37. The Access seekers submit that there is no obligation on the Commission to defer final determination of these disputes pending resolution of those matters. Access seekers argue that to do so would be contrary to the Commission's obligation (in paragraph 152DB(1)(b) of the Act) to 'act as speedily as a proper consideration of the dispute allows'. [AAAP, 1/10, Part 1,p. 2]

38. The Commission is of the view that it is appropriate for it to proceed to make a final determination in this arbitration. The Commission considers deferral would be detrimental to end-users, as certainty over the terms of access to the LSS by competing service providers would be delayed.

The Commission's role and task

39. Telstra has made submissions about the Commission's role under Part XIC and the processes that the Commission adopted in conducting this arbitration. Telstra contends that the draft final determination (DFD) in this dispute 'constitutes a denial of procedural fairness' for a number of reasons, namely:

   - a DFD should only be made after receiving substantive submissions from parties;
   - the DFD is tainted by a denial of a proper hearing and/or prejudgment because the DFD is based on prior conclusions of the Commission rather than parties' submissions in these arbitrations; and
   - the Commission has not carried out its subsection 152DB(1) function of carefully inquiring and investigating the dispute because the Commission has not called for and considered substantive submissions from the parties prior to issuing its DFD.

40. Telstra suggests its concerns could be overcome if, prior to the final determination being made, the Commission:

   - provides a further DFD informed by the parties' submissions (again with consultation paper and reasons) for the parties' review; and
   - calls for further submissions from the parties in relation to that further DFD. [Telstra, 20/9, part 2, pp, 8-15.]

41. Access seekers state that Telstra's submission that the Commission needs to issue another DFD is without substance and is another attempt to delay the finalisation of these arbitrations. [AAAP, 1/10, Part 1, p. 2].

42. Access seekers submit that they are satisfied that the Commission has met its obligations and acted appropriately in conducting the arbitration. Further, they dispute that the DFD was made without sufficient information, noting that the issues in dispute in the joint arbitration hearing have been thoroughly and recently considered, investigated, analysed and argued in other regulatory proceedings concerning the LSS.

Telstra has had ample opportunity to make full submissions and provide relevant evidence to the Commission in past proceedings and in any event, has had a further opportunity to present its case in the current arbitration hearings.

43. Access seekers consider that a DFD is not the final say on the matter as it has no statutory force, but, is useful in assisting parties by focusing the issues for submissions.

44. Access seekers consider the DFD is based upon the Commission's own analysis and deliberation, and the Commission has adhered to its obligations under Part XIC of the Act in making it. Access seekers dispute that a DFD needs to be informed by parties' submissions.

45. Access seekers dispute Telstra's claims that that the Commission applies a higher standard of analysis in considering undertakings as opposed to arbitrations. They consider that given the Commission has relied upon reports and evidence obtained during the assessment of Telstra's LSS and ULLS undertakings, and conducted further analysis, it would seem that a higher standard has been applied.

46. Access seekers submit that Telstra's statements about the Commission obligations in conducting an arbitration are not supported by the Act. In any event, access seekers dispute Telstra's claim that the Commission has not sought parties' submissions as to the matters for determination. Access seekers point to the preceding submissions in the arbitrations, including submissions and response submissions on next steps. [AAAP, 1/10, Part 1, pp. 3-4].

47. In its reply submission, Telstra states that conducting the arbitration 'on the papers' carries a significant risk of the Commission failing to properly consider and carefully inquire into and investigate the dispute. Telstra submitted and requested that the Commission hold an oral hearing. [Telstra, 1/10, Part 1, p. 3].

48. Telstra made a further request for an oral hearing. [Telstra, 15/11]

Commission's views

49. The Commission considers that the measures that it has taken in arbitrating this access dispute are in accordance with its obligations under Part XIC. With respect to Telstra's claim that the Commission has denied it procedural fairness, the Commission does not agree with this assertion. The requirements of section 152CP of the Act impose upon the Commission an obligation to make a written determination (unless the arbitration has been terminated).

50. Subsection 152CP(4) requires the Commission to provide parties with a draft determination before it makes a [final] determination. Accordingly, before any final determination is made, parties to the arbitration are given an opportunity to be heard on the content of the draft determination. In this case the parties were provided with discussion papers and specifically invited to comment on particular issues. Parties were also able to provide general submissions.

51. The Commission notes that section 152DB of the Act also provides that the Commission (in conducting an arbitration) is not bound by technicalities or the rules of evidence and may inform itself of any matter relevant to the dispute in any way it thinks appropriate. The Commission is satisfied that it has taken into account all submissions received and that it is entitled to inform itself in any way it thinks appropriate. The DFD is a reflection of the Commission's views at a certain point in time taking into account the submissions that the Commission had received in respect of this access dispute. The issuing of the DFD is not a prejudgment of issues – it is a draft upon which parties are invited to make further submissions.

52. As outlined above at 1.3 "Consultation Process", the Commission is satisfied that parties have been given a reasonable opportunity to be heard on the issues in dispute in the matter.

53. The Commission is also satisfied as to how the arbitration has been conducted. Any question of how an arbitration is to be conducted is for the Commission to determine (see subsections 152DB(3) and (4)). The Commission notes that Telstra in its submissions on the DFD requested an oral hearing. However, having regard to the experience of the parties in arbitrations, the time allowed for the provision of written submissions (including submissions in reply) on numerous issues, and the manner in which the Commission sought and obtained information relating to its decision, the Commission was satisfied that an oral hearing was not required on any matters.

54. The Commission is of the view that it has conducted the arbitrations properly, and has satisfied the relevant procedural fairness requirements in reaching a final determination in this dispute. The Commission considers that conducting an oral hearing in these matters is unnecessary for the parties to put their case, and would add considerable delay and expense to the parties and the Commission. The Commission has conducted a number of inquiries regarding the LSS leading up to and following the initial declaration of the LSS in 2002, and is well acquainted with the issues that have been raised by the parties in their written submissions in the current arbitration. The Commission has accordingly conducted these hearings on the papers.

3. General approach

3.1 Use of pricing principles

Introduction

55. The Commission first determined pricing principles for the LSS under section 152AQA of the Act in 2002 ('the 2002 LSS pricing principles'). The pricing principles determination, as well as reasons for making it, is contained in ACCC, *Final Decision on whether or not a Line Sharing Service should be declared under Part XIC of the Trade Practices Act 1974*, August 2002.

56. These pricing principles required that prices reflect the Total Service Long Run Incremental Cost (plus a contribution to indirect cost) ('TSLRIC+) of providing access to the LSS. (ACCC, *Final Decision on whether or not a Line Sharing Service should be declared under Part XIC of the Trade Practices Act 1974*, August 2002, pp 83-84). They also require that LSS access prices should not include a contribution to costs that are recovered in other charges. (ACCC, August 2002, at pp 97-98)

57. As part of its inquiry into whether the declaration of the LSS should be extended, varied or should cease, the Commission determined new pricing principles for the LSS ('the 2007 LSS pricing principles'). The new pricing principles also included a schedule of indicative prices for the period from 1 January 2008 to 31 July 2009. These pricing principles are as follows:

- A TSLRIC+ pricing principle should be applied to the LSS;
- A specific cost component should be included in the LSS monthly price, calculated by combining 'LSS-specific costs' with 'ULLS-specific costs' and Telstra's internal equivalent costs for ADSL, and allocating those costs across the number of active ULLS, LSS and ADSL lines;
- A contribution for line costs will not be recovered in the LSS monthly price; and
- Connection and disconnection charges should be set with reference to the amounts charged by third party contractors to Telstra for jumpering work in exchanges, indirect costs and back of house costs.

58. The reasons for these pricing principles are set out in, ACCC, *Review of the Line Sharing Service Declaration – final decision*, October 2007.

59. The Commission is required to have regard to the LSS pricing principles in determining the prices to apply in respect of the LSS. (subsection 152AQA(6) of the Act). The Commission sought the parties' views in initial consultation on the DFD on whether it should apply the LSS pricing principles. After deciding to extend the LSS declaration and determining new LSS pricing principles, the Commission sought parties' views on 7 November 2007 as to the application of these new pricing principles.

Parties' submissions

60. The parties were generally supportive of the use of the 2002 LSS pricing principles. Access seekers support their use. [AAAP, 20/9, Part 1, p.2] [Adam, 20/9, Part 2 – connection, disconnection charges and Managed Network Migration, pp. 2, 13] Telstra also supports their use, except that it considers that LSS access prices should be averaged. Telstra also confirms its view that LSS access prices should include a contribution to the recovery of indirect and overhead costs. [Telstra 20/9, Part 2, p.8] In support of its contention that LSS connection and disconnection charges should be averaged, despite the LSS pricing principles requiring de-averaged charges, Telstra states that the Commission has legitimately and transparently modified its thinking on this issue based on a more informed understanding of underlying cost structures. Telstra points to particular Commission decisions in which these views are expressed. [Telstra 1/10, Response on single connection and disconnection charges, Part 2, pp.1-2.]

61. In their supplementary submissions, access seekers argue that the Commission's extension of the LSS declaration of the LSS and release of revised pricing principles inclusive of indicative prices are very relevant to the making of the final determination. Access Seekers contend that this removes uncertainty around the treatment of line costs, and that prices to be specified in the final determination should be set in line with the indicative prices and not include a contribution to line costs. [AAAP, Submission of the Access Seekers, 15/11, pp. 2-3] [Adam Internet, Submission of Adam Internet, 15/11, pp. 2-3] The access seekers had previously expressed these views to the Commission and Telstra prior to the Commission calling for supplementary submissions.

62. In its supplementary submission Telstra agrees with a TSLRIC+ approach as a basis for LSS charges, but objects to a number of the points of detail contained in the 2007 LSS pricing principles concerning how the TSLRIC methodology should be implemented.

63. Telstra contends that specific costs should not be 'pooled', and that a contribution to line costs should be included in LSS annual charges. [Telstra, LSS supplementary submission, 15/11, pp. 5-7].

64. In relation to connection and disconnection charges, Telstra considers that single connection charges should be based on a 'blended' labour force [Telstra, Supplementary submission: connection and disconnection charges, 15/11, pp. 1-2].

65. Telstra notes there is a discrepancy between the prices set out in the DFD and the Commission's indicative LSS single connection and disconnection charges for 2007-08 that are provided in the 2007 LSS pricing principles. Telstra submits that the indicative prices in the 2007 LSS pricing principles are likely to be more current than those in the DFD and the Commission should update its estimates to be consistent with the indicative prices.

66. Telstra reiterates its objection to the Commission's proposal not to permit Telstra to recover a disconnection charge in circumstances where Adam is participating in the Telstra LSS churn process and Telstra BigPond is not. [Telstra, Supplementary submission: connection and disconnection charges, 15/11, p. 2]

67. Telstra notes the Commission must have regard to the LSS pricing principles in determining an appropriate price for MNMs but objects to the minimum charge being

set for 20 services, instead of a minimum 30 services. Telstra reiterates there is no overlap between annual charges and LSS MNMs in relation to back of house cost estimates and the Commission should allow an amount for activities performed by Wholesale Broadband Infrastructure and Operations and Wholesale customer Services Centre in relation to MNMs. [Telstra, Supplementary submission: connection and disconnection charges, 15/11, pp. 2-3]

Commission's views

68. The Commission is required to have regard to the LSS pricing principles in an arbitration. While the 2002 and 2007 LSS pricing principles share common elements, the 2007 LSS pricing principles introduced particular changes. These were in the nature of refining the existing principles, or adding points of detail. The 2007 LSS pricing principles also include indicative prices. This reflects the further regulatory consideration that has been given to the LSS following its declaration in 2002.

69. The parties agree on the use of a TSRLIC methodology as required by the LSS pricing principles. A detailed discussion of the TSLRIC methodology can be found in 'ACCC, *Access Pricing Principles – Telecommunications - a guide'*, 1997.

70. The Australian Competition Tribunal expressed its general agreement with the approach to applying the long term interests of end-users ('LTIE') test (established by the Commission in its *Access Pricing Principles, Telecommunications – a guide*)[2] and the Commission's use of TSLRIC pricing. In the Tribunal's view, the key principles include:

> *…The price of a service should not exceed the minimum costs that an efficient firm will incur in the long-run in providing the service.*
>
> *The costs are the forward-looking costs, including a normal return on efficient investment (which takes into account the risk involved).*
>
> *Forward-looking means prospective costs using best-in-use technology. The access provider should only be compensated for the costs it would incur if it were using this technology, not what it actually incurs, for example in using out-of-date technology which is more costly. Of course, a firm may be using older technology because it was the best available at the time the investment was made and replacing it cannot be justified commercially. In a competitive market, however, that firm would only be able to charge on the basis of using the most up-to-date technology because, if it did not (in this hypothetical competitive market) access seekers would simply take the service from an alternative service provider.*
>
> *The cost of providing the service should be the cost that would be avoided in the long-run by not having to provide it. Thus, it is the additional or incremental costs necessarily incurred, assuming other production activities remain unchanged.*[3]

71. Further, the Tribunal noted that '… in the general case where access prices need to be regulated, unless pricing is on a TSLRIC basis, efficient investment is unlikely to be encouraged.'[4] The Commission notes that the Tribunal went on to state that:

> *…This discussion should not be taken to suggest that TSLRIC pricing should be imposed at every opportunity. It will often be the case that regulation, including regulated pricing, is not appropriate in given circumstances. It does mean, however, that, in our view, it would generally not be in the LTIE to*

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2 ACCC, *Access Pricing Principles, Telecommunications – a guide* (*Access Pricing Principles Guidelines*), July 1997.

3 *Seven Network Limited (no 4)* [2004] ACompT 11 at [135].

4 ibid., at [136].

depart from TSLRIC pricing where access is regulated. Accordingly, where an access regime requires, or creates an unacceptable risk, of non-TSLRIC pricing, the Tribunal considers that such a regime is unlikely to encourage the efficient use of, and investment in, infrastructure.[5]

72. Similarly, the Tribunal has also stated that, in respect of the LSS, a proper application of the criteria relevant to the assessment of an access undertaking (and which significantly overlap with the subsection 152CR(1) criteria) would require that prices reflect the efficient costs of providing access to the LSS:

> . . . *we would point out that whenever an access provider seeks approval of an access undertaking from the Commission which involves a consideration of a price term by comparing it with costs, it would be necessary, in order to satisfy the statutory framework, that the access provider establish that its costs are efficient costs.*[6]

73. Access seekers do not object to TSLRIC being used in accordance with the LSS pricing principles. Telstra, however, disagrees over how the 2007 LSS pricing principles would require the TSLRIC methodology to be used in setting LSS charges. Telstra's objections are of a general nature, rather than being due to particular aspects of the current dispute. Telstra submits that these aspects of the LSS pricing principles should not be applied as in its view doing so would be contrary to the subsection 152CR(1) criteria. The Commission discusses Telstra's objections against those criteria later in these reasons.

74. The Commission has taken into account both the 2002 and 2007 LSS pricing principles. The Commission is required to have regard to the 2007 LSS Pricing Principles under subsection 152AQA(6) of the Act, as these are the pricing principles currently applying to the LSS. (Subsection 152CR(2) of the Act permits the Commission to have regard to other matters that it considers relevant.) The Commission considers that in accordance with these pricing principles it should in this arbitration determine a monthly access price for the LSS that:

- reflects the TSLRIC+ of providing access to the LSS;
- is based on a specific cost component, calculated by combining 'LSS-specific costs' with ULLS-specific costs' and Telstra's internal equivalent costs for ADSL, and allocating those costs across the number of active ULLS, LSS and ADSL lines; and,
- a contribution for line costs should not be recovered in the LSS annual charge (monthly price).

75. The Commission also considers that it should determine connection and disconnection charges with reference to the amounts charged by third party contractors to Telstra for jumpering work in exchanges, indirect costs and back of house costs.

76. The Commission acknowledges that the 2002 LSS pricing principles provide for access prices being de-averaged. The 2007 LSS pricing principles only require de-averaged prices where the distortionary effect of averaged charges is likely to be significant.

77. In considering LSS access prices in other regulatory decisions, the Commission has acknowledged that, in practice, an averaged access price can be appropriate where the distortionary effect of averaged prices is not likely to be material, that is, where the TSLRIC+ of supplying the LSS does not vary materially between geographic bands. [ACCC, *Assessment of Telstra's LSS undertaking relating to connection and disconnection charges, Final decision*, April 2006, at pp: 56-57]

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5 ibid., at [137].

6 *Re Telstra Corporation Ltd* [2006] ACompT 4 at para 46

78. The Commission acknowledges that the purpose of LSS pricing principles is to inform parties of the likely approach that will be adopted in setting prices in arbitration. However, pricing principles are not the only means by which the Commission can communicate this to interested parties. The Commission can also publish reasons for decision in undertaking assessments or in arbitrations that provide further detail regarding currently held views on relevant matters. Where such guidance has been provided in subsequently published decisions, the Commission considers that it should have regard to those decisions in interpreting the LSS pricing principles. Telstra makes submissions to this effect in respect of LSS connection and disconnection charges.

79. In this arbitration, the Commission has not applied that aspect of the 2002 LSS pricing principles that would have required access charges to be de-averaged. The 2007 LSS pricing principles do not require de-averaged prices in the circumstances applicable to this arbitration, and intervening decisions by the Commission have informed interested parties that this aspect of the 2002 LSS pricing principles might not be applied unless costs differed materially between bands. Here, the relevant costs do not differ materially between geographic bands 1 to 3, which are the areas addressed in the FD.

80. Similarly, it could be argued that some aspects of the Commission's 2002 LSS pricing principles were inconsistent with the 'pooling approach' which has been the Commission's published approach to 'specific cost' allocation since the December 2005 decision on Telstra's LSS and ULLS access undertakings. The 2007 LSS pricing principles expressly require the use of the 'pooling approach'. In these arbitrations, the Commission has applied the 2007 LSS pricing principles in this regard, noting that interested parties were aware since the December 2005 decision that any aspect of the 2002 LSS pricing principles that could be interpreted as inconsistent with this approach were unlikely to be applied.

3.2 Relevant legislation

Introduction

81. The Commission sought the parties' views on legislation that is relevant to the making of the final determination.

Parties' submissions

82. The parties identify Part XIC of the Act as relevant to the making of the final determination. [AAAP, 20/9, Part 1, p. 2]

83. Telstra submits that the *Utilities (Network Facilities Tax) Act 2006* (ACT), and any legislation of a similar purpose that may be passed in future in other states, is also relevant to the final determination. [Telstra 20/9, Pt 2, pp. 19-20]

Commission's views

84. The Commission considers that Part XIC of the Act is relevant to the making of the final determination. The Commission considers that the following sections are of direct relevance to the making of a final determination:

- Subsection 152CP(1) of the Act, which provides that unless the Commission terminates the arbitration, the Commission must make a written determination on access by the access seeker to the declared service.
- Subsection 152CP(2) of the Act, which provides that the determination may deal with any matter relating to access by the access seeker to the declared service, including matters that were not the basis for notification of the dispute.
- Subsection 152CP(4) of the Act, which requires that before making a determination, the Commission must give a draft determination to the parties.

- Subsection 152CP(5) of the Act, which requires that when the Commission makes a determination it must give the parties to the arbitration its reasons for making the determination.
- Section 152CQ of the Act, which sets out restrictions on access determinations.
- Subsection 152CR(1) of the Act, which requires that in making a final determination, the Commission must take certain matters into account, including the long-term interests of end-users, which is defined in section 152AB of the Act.
- Subsection 152CR(2) of the Act, which provides that the Commission may take into account any other matters that it thinks are relevant.
- Section 152DNA of the Act, which concerns backdating and interest.
- Subsection 152AQA(6) of the Act, which requires that the Commission must have regard to a pricing principles determination (made in accordance with subsection 152AQA(1)) if the Commission is required to arbitrate an access dispute under Division 8 in relation to the declared service.

85. The Commission considers that the *Utilities (Network Facilities Tax) Act* 2006 (ACT) could potentially be relevant to the setting of LSS access prices, to the extent that Telstra is liable to a charge under that Act, and that any such cost relates to Telstra's supply of the LSS.

86. However, Telstra has not made a cost claim in respect of liabilities under that particular Act, but rather seeks the ability to require access seekers to make unspecified contributions to liabilities that accrue. The Commission does not consider that this would be appropriate, as it denies access seekers certainty as to the charges that they face for using the LSS and impedes competition, and is unnecessary to ensure cost recovery. Accordingly, the Commission has not specified in the final determination that liabilities under the ACT Act should be passed-through. This means that the contribution that may be appropriate for LSS access seekers to make (if any) towards such liabilities remains a matter for the parties to negotiate.

87. Further, the Commission does not consider that it is necessary to make allowance for the possible introduction of other laws to which Telstra may become liable.

3.3 Section 152CR(1) criteria

Introduction

88. The Commission must have regard to the criteria specified in subsection 152CR(1) of the Act in making a final determination. These criteria are:

    (a) whether the determination will promote the LTIE of carriage services or of services supplied by means of carriage services;

    (b) the legitimate business interests of the carrier or provider, and the carrier's or provider's investment in facilities used to supply the declared service;

    (c) the interests of all persons who have rights to use the declared service;

    (d) the direct costs of providing access to the declared service;

    (e) the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else;

    (f) the operational and technical requirements necessary for the safe and reliable operation of a carriage service, or a telecommunications network or a facility;

    (g) the economically efficient operation of a carriage service, a telecommunications network or a facility.

89. The Commission provided the parties with its preliminary views on how these criteria should be interpreted and sought the parties' comment about its views.

90. In its reply submission, Telstra discussed the East Australian Pipeline case.[7] Telstra contends that principles from the East Australian Pipeline case should be applied by the Commission when considering the statutory criteria and making a determination in this dispute. In particular, Telstra states that the objective of regulatory certainty is implied into the objective of efficient investment under paragraph 152AB(2)(e) of the Act. Telstra submits regulatory certainty means the Commission must give due regard to the statutory criteria set out in section 152CR of the Act and cannot ignore factors or only give them cursory consideration before putting them to one side. Telstra states the Commission is required to weigh up all of the statutory criteria against one another when reaching its determination. [Telstra, 1/10, Part 1, pp 5-6].

Commission's views

91. The Commission is satisfied with its approach towards the interpretation of the criteria listed in subsection 152CR(1) of the Act. Each of the criteria listed in that subsection has been taken into account in making this final determination.

3.3.1 Section 152CR(1)(a) Whether the determination will promote the long-term interests of end-users of carriage services or of services supplied by means of carriage services

Parties' submissions

92. Telstra submits the words 'long term' underpin the overriding objective of Part XIC and should be interpreted in light of the duration of the investment by the access provider as well as the access seeker. Telstra considers the critical issue is that an efficient provider of access recovers its costs from access prices and that below cost pricing necessarily has an adverse impact on long term investment and, hence, long term competition. Telstra states that below cost pricing:

- undermines the incentives for access providers to continue to invest and discourages competitive build
- promotes free riding
- leads to unsustainable short term competition
- does not promote dynamic efficiency, and
- in the long run, results in allocative and productive inefficiencies.

93. Telstra submits that lower access prices are not in the LTIE due to the significant adverse impact on future infrastructure build. In considering the LTIE the Commission must have regard to the objective of promoting competition because of the benefits that result from the process of competition. Telstra states that lower LSS prices may promote certain competitors but will not necessarily promote competition and Telstra will be prevented from being able to compete on the basis of its own efficiencies in telecommunications markets if the LSS price determined is below cost and/or if the line cost contribution is not geographically averaged. [Telstra, 20/9, Part 2, pp. 15-17].

94. Access seekers refer to the Commission's previously stated views that particular terms and conditions promote the interests of end-users if they are likely to contribute towards the provision of goods and services and lower prices, higher quality, or towards the provision of a greater diversity of goods and services. Access seekers submit that to permit Telstra to charge more than efficient costs for the LSS will inflate an access seeker's costs, lessen competition in the supply of broadband services, and

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[7] *East Australian Pipeline Pty Limited v ACCC* [2007] HCA 44.

negate potential benefits of lower prices and improved service quality for broadband services provided to the end-user. [AAAP, 20/9 Part 1, p. 3].

Commission's views

95. The Commission has published a guideline explaining what it understands by the phrase 'long-term interests of end-users' in the context of its declaration responsibilities.[8] The Commission considers that a similar interpretation is appropriate to making a final determination in this arbitration.

96. In the Commission's view, particular terms and conditions promote the interests of end-users if they are likely to contribute towards the provision of goods and services at lower prices, higher quality or towards the provision of greater diversity of goods and services.

97. The Commission also notes that the Australian Competition Tribunal has offered guidance in its interpretation of the phrase 'long term interests of end-users' (in the context of access to subscription television services):

> *…Having regard to the legislation, as well as the guidance provided by the Explanatory Memorandum, it is necessary to take the following matters into account when applying the touchstone – the long-term interests of end-users:*
>
> **End-users: "end-users" include actual and potential [users of the service] …*
>
> **Interests: the interests of the end-users lie in obtaining lower prices (than would otherwise be the case), increased quality of service and increased diversity and scope in product offerings. …[T]his would include access to innovations … in a quicker timeframe than would otherwise be the case …*
>
> **Long-term: the long-term will be the period over which the full effects of the … decision will be felt. This means some years, being sufficient time for all players (being existing and potential competitors at the various functional stages of the … industry) to adjust to the outcome, make investment decisions and implement growth – as well as entry and/or exit – strategies.9*

98. As explained further below, the Commission considers that LSS access prices that reflect the efficient (as opposed to actual) cost of supplying the LSS will best promote the LTIE.

99. To consider the likely impact of particular terms and conditions on the LTIE, the Act requires the Commission to have regard to whether the terms and conditions are likely to result in:

- promoting competition in markets for carriage services and services supplied by means of carriage services;
- achieving any-to-any connectivity; and
- encouraging the economically efficient use of, and economically efficient investment in:
  - the infrastructure by which listed carriage services are supplied; and
  - any other infrastructure by which listed services are, or are likely to become, capable of being supplied.[10]

100. In determining the extent to which terms and conditions are likely to result in the objective of promoting competition, regard must be had to the extent to which the

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8 ACCC, *Telecommunications services — Declaration Provisions: A Guide to the Declaration Provisions of Part XIC of the Trade Practices Act*, July 1999.

9 *Seven Network Limited (no 4)* [2004] ACompT 11 at [120].

10 *Trade Practices Act 1974*, subsection 152AB(2).

terms and conditions will remove obstacles to end-users of gaining access to listed services.[11]

101. The Commission considers that, in assessing whether particular terms and conditions will promote competition, it is relevant to consider markets in which DSL services are supplied (retail and/or wholesale), and to consider whether the terms and conditions will remove obstacles to end-users gaining access to DSL services.

102. This is because the LSS is an input to the provision of carriage services on the non-voiceband frequency spectrum of the line, and this spectrum is typically used to provide DSL services. This approach is consistent with the approach adopted by the Australian Competition Tribunal. (*Re Telstra Corporation Ltd ACompT 4* [2006] at [97], [149])

103. Obstacles to accessing DSL services could be in the nature of DSL infrastructure not being available in the end-user's area, or the price of services that are available being too high, or their quality (measured by reference to, for instance, data transfer rates) being too low.

104. It is also possible that service providers will offer voice over internet protocol (VoIP) services over an LSS. However, the Commission does not consider that, over the period to which the final determination relates, the LSS will be commonly used in order to supply VoIP services. This is due to the specification in the LSS declaration that Telstra is only obliged to supply the LSS where a PSTN voice service is already being supplied on the line. While this does not preclude a VoIP service also being supplied to the end-user, it does limit the value to end-users of competing VoIP services supplied over the LSS, and reduces the class of end-users for whom such services would be attractive. This is because line rental charges would not be avoided.

105. The Commission considers that prices that reflect efficient forward-looking costs of supply will best promote effective competition in the supply of broadband/DSL services. This is because such prices best enable access seekers to compete on an equal footing with other suppliers, including the access provider, in the supply of downstream DSL services.

106. The Commission considers that the terms of access addressed in this final determination do not directly affect the objective of achieving any-to-any connectivity.

107. In determining the extent to which terms and conditions are likely to result in the achievement of the objective of encouraging the economically efficient use of and investment in infrastructure, regard must be had to:

- whether it is technically feasible for the services to be supplied and charged for with regard to technology that is in use, available or likely to become available; and the costs involved in supplying and charging for, the services that are reasonable or likely to become reasonable; and the effects or likely effects that supplying and charging for the services would have on the operation or performance of telecommunications networks;
- the legitimate commercial interests of the supplier or suppliers of the services, including the ability of the supplier or suppliers to exploit economies of scale and scope;
- incentives for investment in the infrastructure by which services are supplied; and any other infrastructure by which services are or likely to become capable of being supplied; and
- the risks involved in making the investment.[12]

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11 ibid., subsection 152AB(4).

12 *Trade Practices Act 1974*, subsections 152AB(6) and (7A).

108. In the Commission's view, the phrase 'economically efficient use of, and economically efficient investment in ... infrastructure' refers to the concept of economic efficiency that consists of three components:

- Productive efficiency – This is achieved where individual firms produce the goods and services that they offer at least cost;
- Allocative efficiency – This is achieved where the prices of resources reflect their underlying costs so that resources are then allocated to their highest valued uses (i.e. those that provided the greatest benefit relative to costs); and
- Dynamic efficiency – This reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities.

109. The Commission considers that it is relevant here to consider use of, and investment in, infrastructure used to supply the LSS (e.g, ordering and provisioning systems and access networks), as well as infrastructure used to supply carriage and/or content services over the LSS, e.g., DSL access multiplexers ('DSLAMs'). This is consistent with the approach adopted by the Australian Competition Tribunal. (*Re Telstra Corporation Ltd ACompT 4* [2006] at [104])

110. Again, the Commission considers that access charges that reflect the efficient, forward-looking costs best meet these considerations. Such charges are consistent with the access provider's legitimate commercial interests and, in particular, enable access providers to exploit economies of scale and scope. These charges also provide correct incentives for the access provider and access seekers to make efficient investments in infrastructure used to supply the LSS and downstream services. By promoting competition, these charges also encourage dynamic efficiency.

111. More recently, on the issue of efficient investment, the Australian Competition Tribunal has stated that:

> *…An access charge should be one that just allows an access provider to recover the costs of efficient investment in the infrastructure necessary to provide the declared service.*[13]
>
> *…efficient investment by both access providers and access seekers would be expected to be encouraged in circumstances where access charges were set to ensure recovery of the efficient costs of investment (inclusive of a normal return on investment) by the access provider in the infrastructure necessary to provide the declared service.*[14]
>
> *…access charges can create an incentive for access providers to seek productive and dynamic efficiencies if access charges are set having regard to the efficient costs of providing access to a declared service.*[15]

3.3.2 Section 152CR(1)(b) The legitimate business interests of the access provider, and the carrier's or provider's investment in facilities used to supply the declared service

Parties' submissions

112. Telstra submits that the expression 'legitimate business interests' is a reference to the interest of a carrier in recovering the costs of its infrastructure and its operating costs and obtaining a normal return on its capital. Telstra also submits that this criterion does not require the costs that are taken into account be efficient – it is in the legitimate

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13 *Telstra Corporation Ltd (No. 3)* [2007] ACompT 3 at [159].

14 *Telstra Corporation Ltd (No. 3)* [2007] ACompT 3 at [164].

15 Telstra Corporation Ltd (No. 3) [2007] ACompT 3 at [176].

business interests of Telstra to recover its actual costs. Telstra acknowledges that the concepts of efficiency are relevant to the Commission's considerations (eg under s 152CR(1)(g)), however, those concepts do not take precedence or exclude the matters requiring consideration under section 152CR(1)(b) [Telstra 20/9, Part 2, p.17]

113. Access seekers submit that it is a legitimate interest for the access provider to receive a normal commercial return, but that charges higher than normal commercial returns would be an abuse of Telstra's dominant position and should not be regarded as legitimate. [AAAP, 20/9, Part 1, p. 4]

Commission's views

114. As outlined in the Commission's Access Pricing Principles, the Commission considers it is a legitimate interest for an access provider to earn a normal commercial return on its investments that have been prudently made.[16] In this regard, the Commission is of the view that the concept of 'legitimate business interests' should be interpreted in a manner consistent with the phrase 'legitimate commercial interests' used elsewhere in Part XIC of the Act.

115. The Commission notes that it would be a legitimate business interest for an access provider to seek to recover its costs as well as a normal commercial return on such investment having regard to the relevant risk involved. It is also the Commission's view that references made in regard to the 'legitimate' business interests of a carrier or carriage service provider and to the 'direct' costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market.[17]

116. As noted in the Commission's consultation paper, the Australian Competition Tribunal has stated that:

> *…The expression "legitimate business interests" is a general expression and is somewhat open-textured. What is "legitimate" conduct or a "legitimate" interest in business may be open to a number of differing interpretations. We consider that a carrier's "legitimate business interests" is a reference to what is regarded as allowable and appropriate in commercial or business terms. In the context of s 152AH(1)(b), the expression connotes something which is allowable and appropriate when negotiating access to the carrier's infrastructure. When looked at through the prism of a charge term and condition of access and its relationship to a carrier's cost structure, it is a reference to the interest of a carrier in recovering the costs of its infrastructure and its operating costs and obtaining a normal return on its capital. (Re Telstra Corporation Ltd [2006] ACompT 4 at [89]*

117. The Tribunal again adopted this position in its review of Telstra's ULLS undertaking.[18]

118. It is the Commission's view that the term "legitimate business interests" does not necessarily extend to include costs associated with all investments, as on occasion there will be the potential for the access provider to make investments that were not efficient. The Commission further notes that an access price should not be inflated to recover any profits the access provider (or any other party) may lose in a dependent market as a result of the provision of access. [19]

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16 ACCC, *Access Pricing Principles Guidelines*, p. 9.

17 Explanatory Memorandum, *Trade Practices Amendment (Telecommunications) Bill 1996*, p.43

18 *Telstra Corporation Ltd* (No. 3) [2007] ACompT 3 at [180].

19 ACCC, *Access Pricing Principles Guidelines*, p. 10.

119. The Commission is satisfied that the LSS Annual Charges it has determined in this access dispute do not impact on Telstra's capacity to earn a normal commercial return on its investments.

3.3.3 Section 152CR(1)(c) The interests of all persons who have the right to use the service

Parties' submissions

120. In Telstra's view, the persons who have rights to use the LSS are not just "access seekers" and, for example, may include end users, such as, Telstra's retail customers who have 'indirect rights' to use the service because they purchase a retail service from Telstra. Telstra states it is not in the interests of either access seekers or end users for the service to be supplied at below cost prices. [Telstra, 20/9, part 2, p.18].

121. Access seekers refer to the Commission's previous statements[20] that access seekers have an interest in being able to compete for end-users on their relative merits. Access seekers consider that conditions that favour one or more service providers over others distort the competitive process and prevent this from occurring. The Access seekers argue that their legitimate business interests are harmed if Telstra imposes high charges upon access seekers, in excess of normal commercial returns and direct costs, as they would be unable to compete with Telstra in the DSL market. [AAAP, 20/9, Part 1, p.4]

Commission's views

122. The Commission notes Telstra's submission concerning Telstra's retail customers having rights to indirectly use line sharing by acquiring a retail service. While the Commission agrees that retail services supplied to end-users involve the use of line sharing, it does not consider that this gives them a right to use the LSS. The Commission concurs with the view of the Australian Competition Tribunal and considers that it is only LSS access seekers that the criterion contemplates.[21] The interests of end-users are considered under other criteria.

123. The Tribunal has stated the principle that:

> *…The interests of persons who have a right to use the LSS, access seekers, are served by an access price that enables them to compete on their merits (that is, on the basis of their own efficiency) in downstream markets.*[22]

124. In assessing whether an approach that led to a higher LSS Annual Charge should be adopted the Tribunal noted:

> *…s 152AH(1)(c) requires us to have regard to the interests of persons who have rights to use Telstra's LSS, that is, access seekers. . . A higher monthly charge would not be in the interests of an access seeker because it would raise its costs and inhibit its ability to compete with Telstra over the provision of retail services to end-users that could be provided using the LSS. (Re Telstra Corporation Ltd [2006] ACompT 4 at [91])*

125. As noted in the *Access Dispute Guidelines*, people who have rights to currently use a declared service will generally use that service as an input to supply carriage services, or a service supplied by means of carriage services, to end-users.[23] In the case of the LSS, the access service could also be used to provide a wholesale service to another service provider.

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[20] ACCC, *Assessment of Telstra's LSS undertaking relating to connection and disconnection charges, final decision*, April 2006, p.15.

[21] *Telstra Corporation Ltd* [2006] ACompT 4 at [91].

[22] ibid., at [138]. This principle was again adopted by the Tribunal in *Telstra Corporation Ltd* (No. 3) [2007] ACompT 3 at [262].

[23] ACCC, *Resolution of telecommunications access disputes – a guide*, p. 57.

126. The Commission considers that this class of persons has an interest in being able to compete for the custom of end-users on the basis of their relative merits. Terms and conditions that favour one or more service providers, including the access provider, over others and thereby distort the competitive process may prevent this from occurring and consequently harm those interests.[24]

3.3.4 Section 152CR(1)(d) The direct cost of providing access to the declared service

Parties' submissions

127. Telstra submits that the direct costs of providing the LSS also includes a contribution to common costs. Telstra refers to the Australian Competition Tribunal's views in *Application by Optus Mobile Pty Limited and Optus Networks Pty Limited* [2006] ACompT 8 that this criterion is concerned with ensuring that the costs of providing the service are recovered. Telstra submits that 'direct costs' mean the actual costs of providing the service, not for example, efficient or forward-looking costs. Telstra also submits that the criterion refers to the direct costs of providing the declared services, which is the LSS, and not the costs of providing any other service. [Telstra, 20/9 Part 2, p. 18].

128. Access Seekers submit that the relevant direct costs for the LSS Annual charges are the specific costs associated with the LSS. [AAAP, 20/9, Part 1, p. 4]

Commission's views

129. The Commission considers that the direct costs of providing access to a declared service are those incurred (or caused) by the provision of access, and includes the incremental costs of providing access.

130. Consistent with the Tribunal's view, the Commission has interpreted this criterion, and the use of the term 'direct costs', as not excluding consideration being given to a contribution to indirect costs. (*Application by Optus Mobile Pty Limited and Optus Networks Pty Limited* [2006] ACompT 8 at [137]) A contribution to indirect costs can be supported by other of the criteria also.

131. However, the criterion does not extend to permitting compensation for loss of any 'monopoly profits' that occurs as a result of increased competition. As outlined above, the 'direct' costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market.[25]

132. The Commission also notes the Tribunal considers the direct costs criterion 'is concerned with ensuring that the costs of providing the service are recovered.'[26]

133. More recently, the Tribunal has noted that direct costs could conceivably be allocated (and hence recovered) in a number of ways, and that adopting any of those approaches would be consistent with this criterion. The Tribunal held that:

> *…Telstra's approach to estimating a per unit cost is likely to be consistent with ensuring recovery only of direct costs. However, while direct costs will be incurred by Telstra in order to provide the declared service, there are a number of cost allocation methods other than that adopted by Telstra (including those suggested by the Commission and other interveners in this matter) that would enable it to recover the direct costs of investment in infrastructure necessary to provide a LSS. (Re Telstra Corporation Ltd [2006] ACompT 4 at [139])*

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24 ibid.

25 Explanatory Memorandum, *Trade Practices Amendment (Telecommunications) Bill 1996*, p. 43.

26 *Telstra Corp Ltd [2001]* ACompT 4 (7 Dec 2001) at [92].

134. Telstra has raised whether this criterion may support the proposition that an access provider should recover its actual costs, even if these do not reflect efficient forward-looking costs. The actual costs of an access provider are not necessarily higher than efficient costs, and can fall somewhat below this level. While this particular criterion could support Telstra's contention that regard should be paid to Telstra's actual costs, other criteria militate against the view that an access provider would be entitled to recover costs above an efficient level in access charges. For instance, the Australian Competition Tribunal has stated the following:

> *Having regard to the conclusions which we have reached it is not necessary to determine whether Telstra's costs were established as efficient costs. However, we would point out that whenever an access provider seeks approval of an access undertaking from the Commission which involves a consideration of a price term by comparing it with costs, it would be necessary, in order to satisfy the statutory framework, that the access provider establish that its costs are efficient costs. (Re Telstra Corporation [2006] A Comp T 4 at [46])*

3.3.5 Section 152CR(1)(e) The value to a party of extensions, or enhancement of capability, whose cost is borne by someone else

Parties' submissions

135. Telstra did not address this criterion.

136. Access seekers did not consider this relevant to the current matter. [AAAP, 20/9, Part 1, p. 4]

Commission's views

137. The Commission's view is that this criterion requires that if an access seeker enhances the facility to provide the required services, the access provider should not attempt to recover for themselves any costs related to this enhancement. Equally, if the access provider must enhance the facility to provide the service, it is legitimate for the access provider to incorporate some proportion of the cost of doing so in the access price.[27]

138. The Commission remains of this view, and has applied this approach in setting access prices in the final determination.

3.3.6 Section 152CR(1)(f) the operational and technical requirements necessary for the safe and reliable operation of a carriage service, or a telecommunications network or a facility

Parties' submissions

139. Telstra considers that this criterion can be relevant to setting access prices as operational and technical requirements can have cost implications, and access prices should permit the recovery of costs that are necessarily incurred to meet these requirements. Telstra submits that the risk of unsafe or unreliable services arises whenever access prices are below the efficient costs of supply [Telstra 20/9, Part 2, p. 19]

140. Access Seekers consider that this criterion is not relevant to these disputes. [AAAP, 20/9, Part 1, p. 4]

Commission's views

141. The Commission considers that this criterion requires that terms of access should not compromise the safety or reliability of carriage services and associated networks or facilities, and that this has direct relevance when specifying technical requirements or standards to be followed.

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[27] ACCC, *Access Pricing Principles Guidelines*, p. 11.

142. The Commission suggested to the parties that this criterion is generally unlikely to be relevant to disputes relating only to the price of access to a service. This is because the access price will have little direct bearing on the adoption of operational and technical requirements necessary for the safe and reliable operation of a carriage service, or a telecommunications network or a facility.

143. That said, the Commission acknowledges that, in the long-run, access prices that are persistently below the efficient costs of supplying a service can, indirectly, compromise the safe and reliable supply of the service. Accordingly, the Commission considers that efficient costs should be based upon a method of supply of the LSS that meets the relevant operational and technical requirements necessary for the safe and reliable operation of the LSS and facilities used to supply the LSS.

3.3.7 Section 152CR(1)(g) the economically efficient operation of a carriage service, a telecommunications network or a facility

Parties' submissions

144. Telstra submits that the criterion requires that access prices should not be set at a level that is below cost. Specifically, below cost pricing creates free riding incentives and the economic distortion arising from below cost pricing is also likely to have a cascading and long term spill over effect into downstream and related markets. Telstra suggests this might lead to an absence of sufficient network investments by the access provider. [Telstra 20/9, Part 2, p.19]

145. Access seekers argue that access charges in excess of the efficient forward-looking costs of the service result in under utilisation of the infrastructure, discourage demand for the service and leads to less investment by access seekers and under investment by Telstra. Access seekers submit that if charges reflect efficient costs then this would encourage more efficient use of infrastructure and provide signals for efficient investment by both Telstra and Access Seekers. [AAAP, 20/9, Part 1, p.5]

146. Access seekers argue regulation has provided for more efficient utilisation of Telstra's CAN by facilitating DSLAM investment and use of all available spectrum on lines [AAAP, 1/10, Part 1, pp. 4-5].

Commission's views

147. As noted in the Commission's *Access Dispute Guidelines*, the phrase 'economically efficient operation' embodies the concept of economic efficiency as discussed earlier under the LTIE. That is, it calls for a consideration of dynamic, productive and allocative efficiency.[28]

148. Further, consistent with the approach adopted by the Australian Competition Tribunal, the Commission considers that in applying this criterion, it is relevant to consider:

- the economically efficient operation of downstream services provided by access seekers using Telstra's LSS, or by Telstra itself in competition with those access seekers; and
- the telecommunications networks and infrastructure used to supply these services. (*Re Telstra Corporation Ltd* [2006] ACompT 4 [94-95])

149. As noted in the *Access Dispute Guidelines*, in the context of a determination, the Commission may consider whether particular terms and conditions enable a carriage service, telecommunications network or facility to be operated efficiently. The Commission considers that, in the context of access prices, prices that reflect the efficient forward-looking costs of the service best meet this criterion.

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[28] ACCC, *Resolution of telecommunications access disputes – a guide*, p. 57.

3.4 Additional matters and information to which the Commission intends to have regard in making the final determinations

150. Subsection 152CR(2) of the Act allows the Commission to have regard to additional matters. The Commission sought the parties' views on whether it should have regard to additional matters.

151. Telstra nominated the *ACT Infrastructure Tax Act* and the possibility of similar legislation ('Infrastructure Tax Acts') eventuating in other jurisdictions. [Telstra 20/9, Part 2, p.19] Telstra also submitted that the Commission should have regard to the fact that Telstra will have to pay GST on any amount received for LSS. [Telstra, 20/9, Part 2, p. 20].

152. Access seekers consider the Commission should have regard to its draft decision on reviewing the declaration of the LSS (ACCC*, Review of the Line Sharing Service Declaration, Draft Decision*, August 2007), and if issued before the final determinations in these disputes, the final decision. [AAAP, 20/9, Part 1, p. 5].

153. In reply, Telstra submits that the ACCC's review of the LSS declaration is not relevant to the determination of the issue in dispute in this arbitration, which takes place pursuant to the current declaration of the LSS. Telstra contends that no regard at all should be given to the draft, as it is merely a draft, and if the Commission is minded to have regard to the draft or final decisions, the parties need to be informed what use the Commission intends to make of those documents. [Telstra, 1/10, Part 1, p. 6].

154. In response, access seekers state that it was not aware of States proposing an infrastructure tax. Access seekers noted that if such legislation was ever enacted, the inclusion of any costs could be part of an overall fixed services review by the Commission. Access seekers agree that the Commission should clarify whether the prices set in the determination are inclusive or exclusive of GST. [AAAP, 1/10, Part 2, p. 10]

155. Telstra also nominated a number of US cases [Telstra letter, 6/11] which it says support averaged LSS prices. Access seekers submit that the Commission should not have regard to the US cases. [AAAP, 12/11].

Commission's views

156. Having gone to the U.S. case reports, the Commission does not consider that they are relevant in its consideration of LSS prices. In relation to the averaging arguments (discussed in greater detail below) the Commission has already independently come to the view that specific costs and connection and disconnection charges should be averaged. The Commission's view that a contribution to line costs should not be included in the LSS annual charges means it is unnecessary to consider here whether or not such a component should be averaged.

157. The Commission has had regard to the remaining matters that the parties raised for consideration. For completeness, the Commission also has had regard to the various documents and matters that are referred to in this statement of reasons, including the 2002 LSS Pricing Principles.

158. In respect of GST, the Commission has made it clear in the final determination that all charges are expressed on a GST exclusive basis.

3.5 Period to which the final determination should apply

3.5.1 Commencement date

Introduction

159. Any or all of the provisions of a final determination may be specified to take effect earlier than the date on which the determination takes effect (ss.152DNA(1)). The

specified date must not be earlier than the date on which the parties to the determination commenced negotiations with a view to agreeing on the terms and conditions of access (ss.152DNA(2)).

160. In the consultation paper, the Commission proposed to backdate certain terms of access in dispute to the date of notification of the access dispute. The Commission advised the parties that it would consider backdating to an earlier time where it could be established that the parties commenced negotiations at a time materially earlier than the date of notification. The Commission sought the parties' views.

Parties' submissions

161. Telstra acknowledges the Commission has the power to backdate provisions of a final determination (FD) pursuant to section 152DNA of the Act. In conjunction with its Access Dispute Guidelines, Telstra also notes that paragraph 152DNA(7)(b) prescribes that the Commission can have regard to other matters it considers relevant such as the matters set out under section 152CR.

162. Telstra submits that the FD should not be backdated. If however the Commission decides to backdate, Telstra submits that the FD should not be backdated to take effect prior to the date of notification.

163. Telstra submits that backdating is unnecessary and inappropriate in circumstances where:

(a) it would not promote the rationale for backdating (which it describes as encouraging parties to negotiate and cooperate to reach an agreement), as the access seeker has been obstructive in negotiations; and/or

(b) it would otherwise not be in the LTIE.

164. In relation to LSS Annual Charges, Telstra acknowledges that the parties negotiated in good faith prior to notification of the dispute, and have continued to do so since that time. However, Telstra submits that its charges were in accordance with determinations that the Commission previously made. Telstra points to references to a $7 to $9 range in the Commission's August 2004 decision.[29] Telstra submits prices should not be backdated in such circumstances, for the following reasons:

(a) Telstra has merely followed the pricing set down by the Commission and under those circumstances it would not be appropriate to apply backdating provisions;

(b) It is contrary to the statutory criteria; and

(c) It creates uncertainty across the industry and discourages parties from commercially resolving matters in the future.

165. Telstra also submits that the Commission has proposed a $2.50 per month charge, which does not include a contribution to line costs, because of concerns that varying its approach to LSS annual charges for the purpose of the FD may have an adverse effect on access seekers in the short term. Telstra submits that any potentially adverse effects described by the Commission cannot occur retrospectively, and so it would be unreasonable and inappropriate for the Commission to backdate its proposed LSS annual charge on this basis [Telstra, 20/9, Part 2, section D5; Part 3, section F].

166. In relation to LSS connection and disconnection charges, Telstra claims that Adam failed to employ the contractual dispute resolution mechanism set out in the CRA and to backdate any further than the date of notification would be to reward Adam for this

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[29] Commission, *A final report on the assessment of Telstra's undertaking for the Line Sharing Service*, August 2004, Public Version.

behaviour. Telstra also submits that although Adam first raised the issue of LSS connection and disconnection charges in June 2005, it did not pursue its request for negotiations further until May 2006. Telstra submits that the Commission should find that the relevant negotiations commenced in May 2006. [Telstra, 20/9, Part 2, sections A, F and H]

167. Telstra also submits that should the Commission decide to backdate connection and disconnection charges, it should adopt the pricing methodologies and contractor rates set out in its submission in determining the prices to apply during the period of backdating.

168. In relation to MNM charges, Telstra reiterates its position that there should be no backdating of the Commission's FD. If the Commission decides to backdate, Telstra submits that in setting the prices to apply during the period of backdating, it would be inappropriate to take into account various cost savings that were achieved during this period on Telstra's own initiative. Telstra submits that taking these cost savings into account would penalise Telstra for implementing these efficiencies. [Telstra, 20/9, Part 3, section A]

169. Adam submits that negotiations commenced with Telstra in regard to LSS charges on 19 July 2004. Adam requests that the FD be backdated to the commencement of these negotiations, but that the charges be specified to apply from 7 May 2005, which is when Adam first acquired the LSS.

170. Adam submits that it is appropriate to backdate the determination as it considers Telstra's conduct during the course of negotiations was vague and tardy. Further, Adam claims that Telstra had significant commercial reasons to delay the progress of the arbitration. Adam believes that backdating would provide an incentive for Telstra to negotiate reasonably on terms and conditions of access in the future. [Adam Internet, 20/9, Part 1, section 3.5; Annexure 2(a)]

171. In response, the parties raised various points disputing each other's contentions. Telstra submits that backdating to 19 July 2004 would give Adam a 'lottery winning-like windfall gain', and would be inconsistent with the provisions of the Act and the Commission's policy on backdating. Telstra claims that it would be illogical to backdate to commence earlier than when Adam first acquired LSS services, and as a result Adam's claim for backdating is not made in good faith.

172. Further Telstra notes that backdating to July 2004 would result in the determination backdating prior to a commercially negotiated agreement that saw LSS Annual Charges reduced from $15 to $9 (Variation to CRA 191 - 31 March 2005) [Telstra, 1/10, Part 1, Annexure 1]. Similarly, Telstra notes that Adam agreed to two variations to its access agreement setting prices with respect to single connection and disconnection charges (2 September 2004) and with respect to MNMs (9 June 2005 under CRA 192) [Telstra, 1/10, Part 1, Annexure A].

173. In each instance, Adam noted in its submission that it considered it had no choice but to accept what it was offered. In response, Telstra notes that Adam did not initiate the contractual dispute resolution mechanism at the time.

174. Telstra claims that Adam had no intention of reaching a commercial agreement on LSS Annual Charges once it raised the issue with Telstra on 27 July 2006, despite Telstra's initial submission that the parties did negotiate in good faith up to and following the notification of the dispute. Telstra also submits that for much of the period for which Adam sought backdated charges for LSS MNMs, there was no formal process in existence, and Telstra was simply seeking to meet customer needs by negotiating migrations on an ad hoc basis.

175. Adam also disputes Telstra's submission that a continuation of LSS annual charges would not disrupt the access seeker's businesses. Adam submits that it has been industry knowledge for some time that the Commission considered that the LSS

charges were inappropriate, and took these Commission decisions into account in formulating its business plans. Adam considers that a change in regulatory approach would still disrupt its business, even if as a result previously applying charges continued to operate [Adam Internet, 1/10, Part 2, section F; Part 3, sections A, F & H].

Commission's views

176. The Commission is required to formulate guidelines about its approach to backdating (ss.152DNA(8)), and to have regard to those guidelines, as well as any such matters as the Commission considers relevant (ss.152DNA(7)). In this arbitration, the Commission has considered the guidelines in deciding whether to backdate. The Commission has also had regard to the LSS Pricing Principles and the section 152CR criteria in deciding the terms to apply in the backdating period.

177. The guidelines are set out in sections 7.4.2 to 7.4.6 of the *Access Dispute Guidelines*.

178. As noted in the explanatory memorandum the backdating provisions are intended to:[30]

> *…encourage commercial agreement and co-operation during access arbitrations by removing incentives for delay and to ensure a considered and reasonable outcome is ultimately applied to the interim period which may otherwise be covered by an interim determination or a commercial agreement which one or more parties may be disputing.*

179. Consistent with this, the guidelines aim to improve incentives to reach commercial agreement and co-operate during access arbitrations.

180. The guidelines provide that the Commission will, in general, be inclined to backdate determinations. However, each case will be considered on its merits. In particular, the Commission is likely to consider whether the manner in which the parties have conducted themselves before and during the arbitration provides grounds for not backdating the determination.

181. If, for example, prior to the notification of the dispute the access provider offered the access seeker price and non-price terms and conditions that are substantially similar to those determined by the Commission and the access seeker refused, then it may not be appropriate to backdate. Similarly, if the access seeker has been tardy in responding to offers put forward by the access provider, then it may not be appropriate to backdate to the start of negotiations.

182. The Commission notes that during the relevant negotiations, prior to the notification of the dispute, Telstra did not offer Adam terms of access substantially similar to those that have now been determined by the Commission. Nor does the Commission consider that Adam acted to delay the arbitration or that Adam had no intention of reaching commercial agreement in relation to the various LSS charges. Accordingly, in accordance with its Guidelines, the Commission considers it would be appropriate to backdate the LSS charges set out in the FD.

183. The Commission considers that LSS Annual Charges should be backdated to take effect from 14 July 2006. This was the date of a teleconference between the parties concerning LSS charges and both parties acknowledge that the LSS Annual Charges payable by Adam was raised. This was followed up by an email on 27 July 2006 from Adam to Telstra that sought to review the LSS Annual Charge following the variation to CRA 191.

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30 Supplementary explanatory memorandum, *Telecommunications Legislation Amendment Bill 1998*, p. 33.

184. The Commission does not consider that it would be appropriate to backdate LSS Annual Charges to commence on a date earlier than this. Although the parties were negotiating over LSS charges before this time, the Commission considers that these negotiations culminated in the execution to a variation to the CRA on 31 March 2005 that reduced LSS monthly charges from $15 to $9 per service. There is no communication between the parties to suggest that this agreement did not resolve the earlier negotiations, and it was not until July 2006 that Adam raised concerns over the level of LSS Annual Charges contained in the March 2005 variation to the customer relationship agreement.

185. The Commission does not consider that its August 2004 decision to reject Telstra's then proposed LSS access undertaking means that it should not backdate in this instance. The Commission's guidance in August 2004 was that an access price of around $7-9 per service in operation (SIO) per month is more reflective of the efficient costs of supplying the LSS than Telstra's (then) proposed access price. This was made in the context of explaining the Commission's decision to reject a LSS Annual Charge of $15 per month. It was not a determination that such a LSS Annual Charge would be specified by the Commission. Further, by the time the relevant negotiations between Adam and Telstra had commenced, the Commission had published its decision to reject a $9 per month charge. [ACCC, Assessment of Telstra's ULLS and LSS monthly charge undertakings (confidential version), December 2005].

186. The Commission does not accept Telstra's submission that LSS annual charges should not be backdated on the basis that a failure to do so would not have adverse consequences. The Commission considers that in present circumstances, a failure to backdate would have serious adverse consequences. The charges that have applied between the parties in the relevant period are not reasonable when assessed against the subsection 152CR(1) criteria and the 2002 and 2007 LSS pricing principles, and so have adverse consequences for the LTIE. Backdating charges that the Commission considers to be more consistent with those criteria and principles is a means by which to redress this harm. It also strengthens incentives for the access provider to set more reasonable charges in future, and promotes efficient entry and business planning by access seekers. This is because they have greater assurance that they will face access charges consistent with the Commission's published approach from the start of access negotiations (should those negotiations fail).

187. In deciding the quantum of LSS annual charges to apply during the backdated period, the Commission has considered the subsection 152CR(1) criteria and the 2002 and 2007 LSS pricing principles. This assessment is provided in section 4 of this statement of reasons.

188. The Commission considers that it should backdate LSS connection and disconnection charges to commence from 2 June 2005, which is the date Adam e-mailed Telstra requesting a review of these charges. Telstra does not dispute that Adam raised these charges with it in June 2005, and acknowledges that Adam subsequently sought information from Telstra relating to connections and disconnections. The Commission does not accept that there was a break in those negotiations.

189. The Commission did not backdate these terms to 19 July 2004 as Adam was not then acquiring the LSS, and would also result in the determination overriding a commercially negotiated agreement during a period in which Adam was not in dispute with Telstra over the contractual terms. In this regard, Adam agreed to variations to its access agreement with respect to LSS connection and disconnection charges on 2 September 2004.

190. The Commission does not consider that a failure to employ a contractual dispute resolution mechanism of itself means that it would not be appropriate to backdate. The Commission's guidelines require consideration of whether the parties have negotiated in good faith. In this case, the Commission is satisfied that Adam conducted its

negotiations with Telstra in good faith, and over a lengthy period, prior to notification of the dispute.

191. In specifying the quantum of LSS connection and disconnection charges to apply, the Commission considered the subsection 152CR(1) criteria and the 2002 and 2007 LSS pricing principles, and in doing so has assessed Telstra's efficient, forward-looking costs of providing LSS connections and disconnections in each financial year within the backdating period. This assessment is discussed further in section 4 of this statement of reasons.

192. The Commission considers that MNM charges should be backdated to 9 June 2005, being a date on which Adam and Telstra were negotiating on MNM charges. This is documented by an agreement between the parties concerning MNM Charges (CRA 192) of that date.

193. The Commission does not, however, consider that CRA192 represented a conclusion to negotiations between the parties on MNM prices. Although this agreement contained prices for MNMs, the agreement notes that these prices would be subject to review and would be lowered if the review established that the specified charges were too high.

194. Telstra subsequently advised Adam on 30 June 2005 that it had reviewed some aspects of its pricing model used to calculate MNM prices and had formed the view that travel costs were overstated in that model. Telstra further advised that its review was continuing and it was anticipated that the final results would be available in late July 2005. It was not until May 2006 that Telstra advised Adam that Telstra's extensive cost modelling had been completed, and that MNM prices would be revised. In July 2006, Telstra proposed these revised MNM charges which, if accepted by Adam, would apply from May 2005. While these revised prices were not put into effect, given Telstra's attachment of conditions to the offer that Adam considered unsatisfactory, it confirms that the charges specified in CRA192 were intended by the parties to be interim prices only to be overridden on conclusion of the cost review, and did not represent a settled position between them.

195. In specifying the quantum of MNM charges, the Commission considered the subsection 152CR(1) criteria and the 2002 and 2007 LSS pricing principles, and in doing so has assessed Telstra's efficient, forward-looking costs of providing MNMs involving the LSS in each financial year within the backdating period. This assessment is discussed further in section 4 of this statement of reasons.

3.5.2 Expiry date

Introduction

196. A provision of a determination may be expressed to terminate on a specified date (ss. 152DNA(4)). Although not currently a requirement of the legislation, the Commission would usually expect to limit the duration of a determination to a certain period. The Commission proposed to the parties an expiry date for the FD of 31 December 2007, and sought the parties' views.

197. On 29 October 2007, the ACCC published its final report on its inquiry into the LSS declaration and determined to extend the LSS declaration until 31 July 2009. In response, Adam wrote to the Commission on 30 October 2007 requesting that the Commission also extend the FD's expiry date until 31 July 2009. On 7 November 2007, the Commission sought a further supplementary submission from parties on what implications, if any, the extension of the LSS declaration has for the making of the FD, including the period to which the determination should apply.

Parties' submissions

198. Adam submits that the 31 December 2007 expiry date proposed by the Commission would be inadequate given the determination is likely to be made in late 2007. Adam

submits that it has incurred significant expense towards obtaining a FD and considers that it is reasonable that the determination remain in force until at least 30 June 2008, but preferably later. Further, Adam notes that the Commission has relied on forecasts for the period up to 30 June 2008 in its consultation paper regarding the DFD, and so would have necessary information available.

199. Adam also points to the Commission's draft decision to continue regulation of the LSS until 31 July 2009. Given this situation Adam considers that the FD should be extended beyond 31 December 2007. [Adam, 20/9, section 3.5]

200. Telstra submits that section 152DNC does not confer power on the Commission to make a FD which extends beyond the expiry date of the declaration of the LSS (being 31 October 2007 at the time of Telstra's submission). [Telstra, 20/9, Part 2, section D5.4]

201. Telstra considers that it would be inappropriate for the Commission to extend the expiry date of the $9 price proposed by Telstra given that it is part of a transitional path towards the LSS price making an appropriate contribution to line costs. [Telstra, 1/10, Part 1, section B.4]

202. In its supplementary submission, Telstra considers that the expiry date of the FD should be no later than 30 June 2008. Telstra submits that the Commission's specific costs model, used to calculate the specific costs component of the price for the LSS, does not estimate the costs of LSS post 30 June 2008. Telstra considers that this makes it inappropriate for the Commission to set a price for the LSS beyond this time.

203. Further, Telstra claims that it is inappropriate for the Commission to apply the indicative prices until 31 July 2009 given the transitional nature of the price set. Telstra notes that the price should be set for the shortest possible period in order for the Commission to determine the appropriate line cost allocation.

204. Finally, Telstra notes that both the Commission and Telstra are in the process of building new cost models and that it would be inappropriate for the Commission to extend the expiry date beyond 30 June 2008 given that the cost models will assist in determining the amount of line costs allocated to the LSS. [Telstra, 15/11, section D.3]

205. Adam notes the Commission's recent decision to continue the declaration of the LSS and announcement of indicative LSS prices for the period 1 January 2008 to 31 July 2009, and submits these are very relevant to the making of the FD.

206. Adam submits that the Commission should extend the FD's expiry date until 31 July 2009, and apply the indicative prices. Adam considers that this is imperative to avoid a further access dispute being lodged within the period of the extended declaration merely in order to obtain the indicative prices. [Adam, 15/11, section 2]

Commission's views

207. On 29 October 2007 the ACCC published its final report on its inquiry into the LSS declaration. [ACCC, *Review of the Line Sharing Service Declaration – Final Decision*, October 2007] A copy of the final report is available at: http://www.accc.gov.au.

208. As noted in the final report, the Commission determined to extend the LSS declaration until 31 July 2009, and to make pricing principles for the LSS that include indicative prices. The indicative prices are for the period from 1 January 2008 to 31 July 2009.

209. The Commission had initially proposed to the parties that the FD should expire on 31 December 2007. This reflected the view that:

- the continued declaration of the LSS beyond October 2007 and the pricing principles that should apply, were currently under review;
- there was the potential for that review to conclude that there should be a change in approach to setting terms of access to the LSS; and

- a two month overlap from the anticipated finalisation of that review and the expiry of a FD in this arbitration appeared sufficient to enable parties to negotiate future arrangements.

210. However, the review of the LSS declaration did not conclude that there should be a change in approach to setting terms of access to the LSS.

211. The two options proposed to the Commission in the most recent submissions are an expiry date of 30 June 2008 or 31 July 2009. The Commission recently specified indicative LSS charges for 2008-09 as part of the 2007 LSS pricing principles. Therefore, having regard to the 2007 LSS pricing principles would, in the Commission's opinion, support the specification of charges up to 31 July 2009 in the FD.

212. The Commission considers that a key consideration in this decision is whether setting charges now for 2008-09 would risk setting charges that are too low, or too high (as compared to what would be set if charges were set closer to the commencement of the period).

213. As Telstra notes, the Commission's cost models do not directly estimate the costs of LSS beyond 30 June 2008. Further 2008-09 costs could depart to some extent from the forecasts that the Commission used in calculating the 2008-09 indicative prices for the LSS. For instance, specific costs per LSS may not remain constant as was assumed or contractor rates for making connections may increase by more than anticipated.

214. However, this of itself is not a reason to defer consideration of these charges. As the Commission noted in its 1997 pricing principles guide [at pages 31-32], it can be appropriate to set future charges on a 'delta approach' without undertaking a full costing exercise. Telstra itself has advocated this approach in these proceedings, as its proposed LSS specific cost model adopts it. Under this approach, earlier charges set under a full costing exercise are adjusted by factors, such as trends in cost (inflation) and demand.

215. In this case, the Commission considers LSS single connection and disconnection and MNM charges can be set in this way. The relevant costs are driven by contractor and back of house staff labour rates, which are relatively stable. ABS indices are available for labour costs in the telecommunications industry, and the Commission considers that it is reasonable to apply this index to derive an efficient cost measure for 2008-09. To ensure a conservative approach, the Commission has not reduced the resulting allowance for back-of-house costs by a productivity factor.

216. The Commission also considers that LSS Annual Charges can now be set for 2008-09 on a delta approach in a way that would not risk setting charges that are too low, or would lead to charges that are too high by a significant amount. This is because data on cost, demand and productivity trends are available to the Commission, and a robust analysis has been undertaken to establish the previous period charges.

217. On a delta approach, it can be expected that, firstly, annual cost measures could increase by an amount in line with general inflation. Inflation could be forecast within a range of 2.75 and 3.25 percent. [RBA, *Statement on Monetary Policy*, 12 November 2007, Table 16, p.69] However, demand for line sharing (as shown by LSS and ADSL demand) continues to grow, and as a result unit costs would be expected to fall. Support for this view comes from Telstra submitting a report in these proceedings that its recent TFP growth (unit cost reductions) across its fixed-line network is in the order of 7 per cent per annum. Also, in its proposed cost model, Telstra adopts a negative delta factor (cost decline) in calculating 2007 charges. In these circumstances, a slight reduction in LSS annual charges would appear appropriate on a delta approach.

218. In the 2007 LSS pricing principles the Commission took the approach that the underlying specific costs would likely remain constant in 2008-09 from their average levels since the introduction of the service. Accordingly, the Commission considers

that applying the indicative LSS annual charges for 2008-09 would represent a conservative approach, as it would tend to slightly overshoot unit costs anticipated under a delta approach.

219. In determining the expiry date, and the related issue of the charges that are to apply up to that time, the Commission has considered the subsection 152CR(1) criteria and the LSS pricing principles. The Commission considers that these considerations support an expiry date of 31 July 2009, and the application of the 2008-09 LSS indicative prices in the FD. In the following analysis, the Commission focuses on 2008-09. More detailed analysis of the charges to apply up to and including 2007-08 are provided in chapter 4 of these reasons.

Assessment against subsection 152(1) criteria

220. The Commission considers that specifying an expiry date of 31 July 2009, and setting access charges to apply up to then, would best promote the LTIE (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the objective of encouraging the economically efficient use of and the economically efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

221. Firstly, this will promote competition by aligning the 2008-09 LSS charges with the efficient forward-looking cost of supplying the LSS. The Commission considers that such charges best promote competition. This is because over the long run they lead to conditions that allow the access provider and access seekers to compete in downstream markets on their relative merits, and will remove obstacles to end-users accessing services, including those of higher quality and/or lesser price.

222. Also, setting prices to apply until 31 July 2009 would provide greater certainty to the parties of the prices to apply, given the history of failed negotiations and the likelihood that they will be unable to agree on prices to apply for 2008-09. This greater certainty will of itself promote competition.

223. The Commission does not consider that this decision affects the objective of achieving any-to-any connectivity.

224. The Commission considers that addressing 2008-09 charges in the FD is likely to encourage the efficient use of and investment in infrastructure, and is consistent with Telstra's legitimate commercial interests. Doing so will not prevent Telstra from recovering its direct costs together with a normal risk-adjusted return on its investments, or exploiting economies of scale or scope. The Commission considers that the charges to apply would not be below the unit costs that Telstra will face in 2008-09, including a normal risk adjusted return. Further, by adopting an approach that promotes competition, demand for ADSL services will be encouraged, and this will further drive economies of scale and scope. Telstra remains able to exploit economies of scale and scope across all stages of production of its ADSL services. Similarly, addressing 2008-09 charges in the FD would promote incentives for investment in infrastructure, such as DSLAM networks and LSS ordering systems provided that the charges that are specified do not preclude the recovery of efficient investments and a normal *risk-adjusted* return. By allowing for a risk-adjusted rate of return, the Commission has regard for investment incentives (paragraph 152AB(6)(c)), and the risks involved in making these investments. (subsection 152AB(7A)).

225. The matters identified in paragraph 152AB(6)(a) are not affected by this decision.

226. The next criterion is the legitimate business interests of the provider and its investment in facilities used to provide the LSS (paragraph 152CR(1)(b)). This criterion is discussed as part of the first criterion. The Commission considers that specifying charges for 2008-09 is not of itself contrary to this criterion. Further, the Commission

considers that applying the 2008-09 LSS indicative prices would not be contrary to these interests, as those charges would not be below the unit costs that Telstra will face in 2008-09

227. The next criterion is the interests of all persons with rights to use the LSS (paragraph 152CR(1)(c)). Access seekers' interests lie in being able to compete on their relative merits. Setting the access charges up to 31 July 2009 clearly promotes these interests.

228. The next criterion is the direct costs of providing access to the LSS (paragraph 152CR(1)(d)). It is concerned with ensuring that Telstra will be able to recover its costs in providing access. Again, setting an expiry date of 31 July 2009 is not of itself contrary to this interest. Further, by taking a conservative approach to the unit costs that Telstra is likely to face in 2008-09 in setting the LSS indicative prices, applying the indicative prices in 2008-09 would not be contrary to this criterion.

229. The Commission does not consider that the next two criteria inform this decision (paragraph 152CR(1)(e)-(f)).

230. The last criterion is the economically efficient operation of a carriage service, a telecommunication network or facility. (paragraph 152CR(1)(g)) The Commission has considered the efficient operation of the LSS and ADSL services, and Telstra's and the access seeker's networks and facilities used in the supply of those services. The Commission considers that addressing 2008-09 charges in the FD will of itself promote their economically efficient operation, by bringing greater certainty to Telstra and the access seekers concerning the terms and conditions to apply. The Commission further considers that applying the 2008-09 indicative prices for the LSS will also promote economic efficiency. This is because the Commission considers those prices are consistent with efficient costs. The promotion of competition will also encourage dynamic efficiency.

231. In summary, the Commission considers that specifying an expiry date for the FD of 31 July 2009 (and specifying terms of access to apply in 2008-09) will provide greater certainty to the parties, and provide greater assurance that the charges to apply in 2008-09 will align with efficient costs, inclusive of a normal risk-adjusted return on investment. This will promote competition, encourage economic efficiency and encourage economies of scale and scope, and provide efficient investment incentives. This is also consistent with the 2007 LSS pricing principles, including the indicative prices.

232. Further, the Commission considers that setting this expiry date would not risk specifying LSS charges that are below the direct cost of providing access, or would otherwise be contrary to the legitimate business or commercial interests of Telstra. Accordingly, the Commission has decided to specify an expiry date for the FD of 31 July 2009.

3.5.3 Interest

Introduction

233. Subsection 152DNA(6) of the Act provides the Commission with a discretion to require interest to be paid in instances of backdating at a rate specified in the determination. The Commission proposed to the parties that interest should be included on under or over payments, and suggested this be at the Reserve Bank of Australia Large Business Variable Indicator Rate (RBA Rate). The Commission sought the parties' views.

Parties' submissions

234. Adam submits that any backdated payments should include an interest component. Adam claims that this would ensure that Telstra does not benefit from the delay arising

from the arbitration process and that incentives for delay in other negotiations would be reduced.

235. Adam objects to the use of the RBA Rate. Adam submits that this approach ignores the CRA it reached with Telstra, which specifies a higher rate of interest to apply to monies unpaid or withheld, and therefore amounts to an unreasonable application of the ACCC *Access Dispute Guidelines*. Adam claims that the existing CRA provides an appropriate estimate of opportunity cost and can in no way be construed as either unreasonable or a penalty.

236. Adam claims the RBA Rate should only be used if no reasonable alternative is available. Further, Adam submits that the RBA Rate is not reflective of the opportunities that Adam has foregone as a result of having to make excessive payments to Telstra. Adam provides details of the possible opportunity cost to it had it invested these funds in expanding its own DSLAM network.

237. Finally, Adam considers it inappropriate that interest is not payable for the 21-day period following the determination coming into effect and the final date for payment of the settlement amount. Adam anticipates that the relevant interest component over this 21-day period is likely to be material. Adam submits that the date of payment should be 7-days following the date the determination comes into effect rather than 21-days. [Adam Internet, 20/9, Part 1, section 3; Annexure 2(b)]

238. Telstra submits that if the Commission determines that the FD is to be backdated and that interest should be payable, the appropriate rate to use is the 90-day bank bill rate. Telstra considers this is appropriate as it is usual to place disputed funds into a zero-risk deposit account. [Telstra, 20/9, LSS annual charges, Part 2, section D.5.5; and 20/9, single connections and disconnections, Part 2, section H]

239. Telstra disagrees with Adam's interpretation of the ACCC *Access Dispute Guidelines*. Telstra submits that the Commission may have regard to an interest rate agreed between the parties, but is not bound to apply it and that in the circumstances, the Commission should not do so.

240. Telstra submits that the interest provision in its CRA applies only in the event of a billing dispute which is resolved in favour of Adam and is therefore not applicable to the current situation. Further, Telstra notes interest payments made pursuant to the arbitration regime in Part XIC of the Act are neither intended to be a windfall to the party receiving interest, or a punishment of the party paying interest. On that basis Telstra submits that any interest payable should not be compounded daily.

241. In relation to Adam's claim that the interest rate should also reflect lost opportunity costs, Telstra claims that insufficient evidence has been provided to substantiate opportunity costs and that the Commission should not rely on those assertions. Further, Telstra claims that the interest rate proposed by Adam does not acknowledge the inherent riskiness of the investments they might have made.

242. Finally, Telstra submits that the period of time within which the settlement amount is to be paid should not be less than 21-days after the determination takes effect because the steps involved in determining and negotiating the settlement amount is complex and time-consuming. Further, instead of paying the settlement amount to Adam as a lump sum, Telstra requests that the settlement amount should be offset against any future payments that Adam pays to Telstra. [Telstra, Response to Adam, 1/10, Part 1, section B.5 and Annexure 1]

Commission's views

243. Under subsection 152DNA(7) of the Act, the Commission is required to have regard to its guidelines and such other matters as it considers relevant in determining whether or not interest should be charged.

244. The *Access Disputes Guidelines* provide that the Commission 'will generally' provide for the payment of interest on 'backdated amounts' (the amounts underpaid or overpaid by an access seeker having regard to the charges and the period of backdating that are specified in the FD).[31] The interest component is used in conjunction with backdating to remove the incentive for delay.

245. However, the Commission evaluates interest on a case-by-case basis and does not consider that interest is automatically payable in every circumstance where backdating of a FD occurs.

246. As specified in the Guidelines, where interest is to be paid, it will be calculated on the amounts of money that have been overpaid (or underpaid), and will usually be calculated by reference to:

- the volume of services supplied by the access provider to the access seeker over the backdating period; and
- the charges that are specified in the FD.

247. Further, the rate of interest should reflect the opportunity cost of the overpayment (or underpayment) and, in general, daily compounding will be appropriate. Lastly, the guidelines also suggest that the opportunity cost could be assessed by reference to the rate applicable to debt financing.

248. In the current arbitration, the Commission considers that it is appropriate to specify that interest is charged on the overpayments that have occurred. Given the time value of money, Adam would be denied the full benefit of the determination in the absence of an award of interest.

249. The Commission has specified that the RBA Rate should be used to calculate interest, and interest shall be charged on a daily basis and compounded. Interest is to be paid from the date of each overpayment, and ending on the day the FD takes effect. A lump sum payment is to be made by Telstra to Adam 21-days after the determination takes effect. This is not to say that a CRA rate could not be used as Adam suggests, but in this case the Commission has chosen to adopt the lesser RBA Rate.

250. The Commission considered the alternative rate of interest put forward by Adam. The Commission was not satisfied that all overpayments would necessarily have been used to fund long-held investments, as opposed to being used to meet expenses or retire existing debt, or that any such investments would in fact yield a rate of return that Adam suggested. Further in regard to Telstra's submission, the Commission considers that the 90 day bank bill rate does not represent the opportunity cost of money to Adam.

251. The Commission considers that the backdated amount is to be paid and not credited against current or future invoices, unless the parties agree otherwise. This is the usual approach. The Commission accepts that there is the potential for the effects of the FD being realised by the access seeker, and for interest calculations to be unnecessarily complicated, were Telstra's suggested approach to be adopted. Telstra remains able to separately obtain payment on any accounts as they become payable by Adam, and there is no suggestion that Adam would be unable to pay these accounts as they fall due.

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[31] ACCC, *Resolution of telecommunications access disputes – a guide*, p. 63

4. Terms & Conditions Addressed in Joint Hearing

4.1 LSS annual charges

4.1.1 Background to dispute over LSS annual charges and overview of approach

252. Telstra proposed in previous regulatory proceedings an LSS annual charge of $9 per month, which was opposed by access seekers, and considered not to be reasonable by both the Commission (December 2005) and the Australian Competition Tribunal (June 2006). Following these rulings, Telstra continued to require access seekers to pay a $9 per month charge.

253. In December 2006, the Commission issued interim determinations in other LSS access disputes (Chime and Request) reducing the LSS annual charge paid by those access seekers to $3.20 per month. These charges reflected an estimate of Telstra's incremental costs of supplying line sharing to access seekers and to itself that results from applying the approach outlined in the Australian Competition Tribunal's ruling[32].

254. The Commission foreshadowed that further analysis may result in these charges being revised. In July and August 2007, the Commission issued FDs, in the Chime and Request disputes, which revised the LSS annual charge to $2.50 per service per month. The Commission proposed this level of charge as a result of further analysis of Telstra's incremental costs of supplying line sharing to access seekers and itself consistent with the Tribunal's ruling.

255. On 16 August 2007, the Commission provided to the parties a DFD specifying an LSS annual charge of $2.50 per month to apply up to 31 December 2007. Consistent with the LSS pricing principles that have been in place since 2002, the proposed $2.50 per month charge did not include a contribution to the costs of the line over which line sharing is supplied.

256. The Commission has for some time recognised that economic efficiency can be enhanced by the inclusion of an appropriate contribution to line costs in LSS annual charges. However, where line costs are fully recovered in other charges, the inclusion of such a contribution in LSS annual charges would lead to an over-recovery of cost. In these circumstances, reductions (rather than conditional rebates) in charges for other network services, such as wholesale line rental, are needed in order to avoid any such 'double dipping'.

257. The Commission recognises that rebalancing charges in this way may take time, has the potential to disrupt competition in DSL services if done too quickly, and is dependent upon Telstra restructuring its existing charges for other services.

258. Accordingly, the Commission consulted the parties on whether there was a real prospect for rebalancing to take effect before 31 December 2007, which was the then proposed date on which the FDs would expire, and, if so, whether a contribution to line costs should be considered for inclusion within the LSS Annual Charges to be specified in the FD.

259. On 24 October 2007, the Commission revised the LSS pricing principles. The 2007 LSS pricing principles provide that LSS charges are not to contribute to line costs. The Commission consulted the parties on the implications of this decision for the FD.

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[32] *Re Telstra Corporations Ltd* [2006] ACompT 4

260. The Commission also consulted the parties on the appropriate charge to reflect the incremental (specific) costs of supplying the LSS.

4.1.2 Participants

261. Telstra, Adam, Agile, Amcom and Primus participated in the joint hearing on this issue.

4.1.3 Current charges

262. Adam, Agile, Amcom and Primus are each in dispute with Telstra over LSS annual charges. These charges are addressed in CRA Table 191.10. The parties are currently paying LSS access charges in line with the FDs made in earlier LSS access disputes, due to a clause in the CRA that passes through charges in this way.

4.1.4 Prior consideration

263. LSS annual charges have been considered by the Commission in a number of proceedings – ACCC, *Final report on the assessment of Telstra's undertaking for the Line Sharing Service (confidential version*), August 2004; ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings (confidential version*), December 2005; ACCC, *Reasons for interim determination*, 21 December 2006; ACCC, *Publication of Final Determination and associated statement of reasons – Chime/Telstra LSS access dispute*, August 2007; ACCC, *Publication of Final Determination and associated statement of reasons – Request/Telstra LSS access dispute*, August 2007.

264. These charges have also been considered by the Australian Competition Tribunal – *Telstra Corporation Ltd* [2006] ACompT 4.

4.1.5 Other regulatory consideration of LSS annual charges

265. The Commission conducted a declaration inquiry in respect of the LSS as it was scheduled to expire in October 2007. The final report of this inquiry was published on 29 October 2007. [ACCC, *Review of the Line Sharing Service Declaration – Final Decision*, October 2007]

266. As noted in the final report, the Commission determined to extend the LSS declaration until 31 July 2009, and to make pricing principles for the LSS that include indicative prices.

4.1.6 Principles to apply

267. The Commission initially proposed to the parties that LSS annual charges should be determined having regard to the LSS pricing principles as issued in 2002. Under the LSS pricing principles, two components are considered in calculating the LSS annual charge:

   (i) a contribution to the efficient costs of the line over which the LSS is supplied ('line costs'); and

   (ii) the efficient incremental (or 'specific') costs associated with the LSS. Efficient costs are measured by means of a TSLRIC methodology. This methodology has been discussed earlier in these reasons.

268. Following the finalisation of the declaration inquiry into the LSS in October 2007, the Commission sought the parties' views on the implications of the revision of the pricing principles for the FD.

269. The 2007 pricing principles maintained the position that LSS prices should be cost based, and that TSLRIC is the cost methodology that should be used. The 2007 pricing principles further provided that:

(i) there should be no contribution to line costs in LSS access charges; and,

(ii) the efficient incremental (specific) costs to be recovered in LSS annual charges, should be calculated by combining 'LSS-specific costs' with 'ULLS-specific costs' and Telstra's internal equivalent costs, and allocating those costs across the number of active ULLS, LSS and ADSL lines.

270. The parties' submissions regarding the use of these principles have been discussed previously. The parties are generally supportive of the use of the TSLRIC methodology specified in each of the 2002 and 2007 LSS pricing principles, although as noted elsewhere, Telstra makes submissions against applying certain aspects of them.

4.1.7 Contribution to line costs

Introduction

271. The Commission has considered, but not previously recognised, a contribution to line costs in LSS annual charges. This is because line costs are being recovered through other charges, and in particular line rental (LR) charges.

272. In the August 2007 consultation paper, the Commission advised the parties of its preliminary view that, if any such contribution is to be recognised in LSS charges, it should only be recognised prospectively following a rebalancing of LSS and wholesale line rental (WLR) charges.

273. The Commission initially sought the parties' submissions on:

(i) whether, at a practical level, a rebalancing of LSS and WLR charges could be implemented during the period of the FD; and

(ii) the likely effect on the LTIE, and the other subsection 152CR(1) criteria, of implementing a rebalancing of LSS and WLR charges during the period of the FD, including the consequences for the LTIE of not adopting a transition path approach.

274. The Commission did not seek submissions on how any such contribution should be calculated. Rather, parties were advised that those submissions would be sought only if the Commission formed a view that such a contribution should be recognised in the LSS annual charges and was to apply within the period of the FD.

275. Subsequent to receiving parties' submissions, the Commission concluded its inquiry on the declaration of the LSS and published pricing principles to apply until July 2009. The Commission called for further submissions on the possible implications of these decisions for the FD.

276. The Commission also reviewed Telstra's regulatory accounting framework (RAF) reports for 2006-07 to test whether Telstra was recovering its line costs. This review was undertaken in the course of this arbitration hearing following Telstra's submissions that it was not recovering its line costs. The Commission compared the revenues and costs that Telstra had reported for those services that use the Telstra CAN as the access technology, and to which Telstra allocates line costs in its RAF reports.

277. The Commission advised the parties that on its review of the Telstra 2006-07 RAF returns, Telstra had reported revenues on these services in excess of allocated costs, including allocated CAN costs, and that the observed surpluses exceed the small proportion of CAN costs that Telstra allocates to other RAF services. The Commission suggested to the parties that this indicated that Telstra was recovering its line costs, and sought the parties' views. The Commission provided Telstra with the calculations that supported this analysis.

Parties' submissions

278. Telstra submits that a line cost contribution should be included in LSS annual charges. Further, Telstra contends that it is not currently recovering the costs of the line, and

that WLR prices should not be reduced as the LSS annual charges increase. Telstra submits for completeness that, if LSS and WLR charges are to be rebalanced, then a rebate system could be introduced within a matter of weeks of the Commission advising its view on the amount of line cost that should be allocated to each service. The minimum period required to do this would be two weeks from this date, although six weeks would be preferable to better allow wholesale customers to understand and plan for the change in arrangements. [Telstra 20/9, Part 3, p.20]

279. Telstra submits that a line cost contribution could be implemented during the period of the FD. Telstra considers that doing so would in the long run strengthen competition, and could be implemented in a manner that did not disrupt competition in the short term. Telstra proposes that a line cost contribution be set as the difference between the 'specific cost measure' and the rate that has generally prevailed ($9). Telstra submits that this contribution would not disrupt competition, as it would reinstate or maintain the LSS annual charge at levels that prevailed when access seekers made their investments in DSLAM networks.

280. Telstra submits that not including a line cost contribution would be detrimental to the promotion of ULLS-based competition. Telstra submits that ULLS should be preferred over the LSS as the mode of access because it would bring the benefits of quasi-facilities based competition to voice services in addition to data services. Telstra considers the ULLS will be available in all areas where the LSS is available. Telstra also considers that not including a line cost contribution would be detrimental to the efficient use of and investment in infrastructure necessary for full-facilities based competition. [Telstra 20/9, Part 3, pp. 4-7] Telstra cites data that it, in its view, suggest that regulated access to the LSS and ULLS is discouraging investment in competitive access infrastructure. [Telstra, 20/9, Part 1, pp.5-7]

281. Telstra acknowledges that an existing LSS based competitor would be prevented from migrating its services onto the ULLS, as Telstra's ordering and provisioning systems do not support such migrations. Telstra explains that this is due to its view that there is no business case for migrations between the LSS and ULLS platform; but Telstra advises that if such a business case becomes evident to Telstra, it is willing to reconsider its position. [Telstra 20/9, Part 3, p.9] Telstra further advises that it has conducted trials of migrations using its current systems, and this confirmed that significant systems development would be required before services could be migrated. [Telstra 15/11, p.4]

282. Telstra considers that including a line cost contribution will promote efficient investment in broadband infrastructure. Telstra considers that a line cost contribution is necessary to ensure that it efficiently invests in maintaining its CAN, as efficiency is promoted by these costs being recovered from line rental and LSS charges. Also, an access charge for the LSS of less than $9 per month makes the business case for an investment in new broadband infrastructure (including a fibre to the node (FTTN) network) impossible. [Telstra 20/9, Part 2, p.2; Part 3, p.3, 7] As noted above, Telstra proposes a line cost contribution that results in LSS annual charges of $9 per month.

283. Further, Telstra submits that a lesser LSS annual charge would not promote investment by competitors, either in a bypass access network or an overlay DSLAM/MSAN network. In support, Telstra submits that investment in DSLAM networks have been made at an LSS annual charge of $9 per month. Further, alternative investments would be made by access seekers should they no longer acquire the LSS, such as investments in ULLS-based networks, or alternative access networks. [Telstra, 20/9, Part 3, p.5, 7-8]

284. Telstra submits that service providers, including those that already operate an access network, have been reluctant to invest in wholly independent technologies, and have instead limited their investments to DSLAM networks that rely upon ongoing access to Telstra's CAN. Telstra submits that this indicates that access prices to Telstra's copper

network are too low. [Telstra, 20/9, 'Lack of Telecommunications Investment' annexure, pp.4-7] Telstra also submits that LSS access charges in Optus HFC areas should be set at Telstra's proposed rates, as intense rivalry will result between Telstra and Optus in the provision of access network services. [Telstra, 20/9, 'Lack of Telecommunications Investment' annexure, pp.11-14]

285. Telstra subsequently provided a copy of a report that it considers supports the view that lower access prices deter investment in alternative access networks. [LECG, *Access regulation and infrastructure investment in the telecommunications sector: an empirical investigation*, September 2007] Telstra restated its view that the Commission should adopt Telstra's commercial offer for LSS annual charges within the footprint of the Optus HFC network. [Telstra, 26/10] Telstra's submission was directed towards any lowering of LSS access charges below this level (i.e., $9 per month), but as the line cost contribution for which Telstra contends effectively acts to maintain this level of charge, this submission is discussed as part of the consideration of the line cost contribution.

286. Telstra also states that including a contribution to line costs is consistent with the recovery of its direct costs of providing the LSS, and its other legitimate interests. Telstra submits that it is not recovering its line costs and a failure to include a line cost contribution in such circumstances will ultimately undermine Telstra's ability to maintain, renew and extend the access network [Telstra 20/9, Part 3, p.8] In support of this contention, Telstra points to a shortfall between the line cost measure Telstra obtains from its PIEII cost model, and yields (average revenue) earned on retail line rental products. [Telstra 20/9, Part 3, pp.10-15; Annexure 2]

287. Telstra also states that including a contribution to line costs is consistent with all persons who have rights to use the LSS. Telstra considers this is the case where the contribution does not lead to a price higher than $9 per month, as access seekers have been able to acquire the LSS at this rate. Further, LSS access seekers should have been aware of the probability of making a contribution to line costs in LSS annual charges from the 2002 LSS pricing principles. [Telstra, 20/9, p.9]

288. Telstra did not oppose the use of the 2007 LSS pricing principles, but considers that the Commission should not apply that aspect of the principles that preclude inclusion of a line cost contribution in LSS annual charges. Telstra states that the 2007 LSS pricing principles did not provide for an allowance to line costs on the basis that necessary information was not to hand. Telstra submits that the Commission should now investigate this matter and obtain the necessary data as part of this arbitration. [Telstra, 15/11, supplementary submission, pp.6-7]

289. Telstra objects to the Commission's approach to assessing whether line costs are being recovered. Telstra notes that its RAF returns show that its *end-user access revenues* do not cover the costs that Telstra allocates to those services. Telstra submits that including costs and revenues associated with services in addition to end-user access is inappropriate, as this requires other services to contribute to line costs. Telstra submits that the Commission's approach to access charges generally do not permit these services to continue to make a sufficient contribution to line costs. Further, although the inclusion of a contribution to line costs in LSS annual charges would of itself have only a minor effect on the profitability of Telstra's suite of CAN-based services, the exclusion of such a contribution would create a significant cost asymmetry whereby Telstra would be impeded in its ability to compete with access seekers. Telstra also considers that having regard to the profitability of all CAN-based services would be inconsistent with the Commission's general approach to regulation. [Telstra, 15/11, supplementary submission, pp.3-5]

290. Telstra also provided submissions to the effect that the line cost contribution should be averaged. Telstra provided DSL demand data for Band 4 that in Telstra's view mean

that there would be opportunities for competing LSS based services in those areas if the line cost contribution was averaged. [Telstra, 20/9, pp.15-19 and annexures]

291. Access seekers submit that a contribution to line costs should not be included in LSS annual charges.

292. AAAP submit that rebalancing would be required before a line cost contribution could be legitimately recognised, as Telstra is recovering its line costs, and this would take time, as Telstra would need to demonstrate that its wholesale charges have reduced by the requisite amount. AAAP consider this may extend beyond just WLR charges, and have implications for ULLS, PSTN, ADSL and LCS charges. [AAAP, 20/9, pp. 10-11]

293. AAAP submits that a FTTN network is becoming increasingly likely, and that such a network deployment would render LSS and WLR pricing irrelevant. If so, then any possible benefits of a rebalancing could not be realised. [AAAP, 20/9, p. 11]

294. AAAP submit that introducing a contribution to line costs in LSS charges would disrupt their current businesses, and doing so without a transition path will cause them severe financial hardship. AAAP submit that, in reliance on the 2002 LSS pricing principles, when acquiring the LSS they have de-emphasised the supply of basic access in favour of broadband and VoIP solutions. And so, each would face higher access charges even if WLR charges reduced by the same amount as LSS charges increased. In this regard, Primus submits that it would not anticipate its LSS–based customers acquiring voice services from Primus, and the other access seekers advise that they are data-only service providers. Each of the access seekers provides details of the increase in monthly charges they would face if rebalancing occurred. These calculations were based on an illustrative scenario that the Commission outlined to the parties in the August 2007 consultation paper.

295. AAAP submit that the likely effect of including a line cost contribution in LSS annual charges would be to force data-only providers to change to offering bundled voice services. AAAP submit that developing business processes to support voice services would take time and resources, and this would divert them from competing strongly in the supply of DSL.

296. AAAP also submit that additional difficulties would be encountered in moving to ULLS based supply. These include the absence of a migration path between the LSS and ULLS, additional complexity in ordering, provisioning and fault handling of services, and constructing and operating additional network elements such as MSAN, softswitch and interconnect. [AAAP, 20/9, pp.12-13, Annexures]

297. AAAP dispute that there is a business case to supply LSS based services in Band 4, and confirm that they would be unlikely to supply in those areas regardless of the approach taken to line costs in these proceedings. Access seekers note the overwhelming majority of LSS are located in Bands 1 and 2, and that there are additional operational difficulties to supply in Band 4 areas. [AAAP, 20/9, pp.1-2]

298. AAAP support the use of the 2007 LSS pricing principles, and note that those principles preclude the inclusion of a line cost contribution in LSS annual charges. [AAAP, 15/11, pp.2-3] AAAP consider that Telstra's 2006-07 RAF returns demonstrate that Telstra is recovering its line costs. [AAAP, 15/11, p.5]

299. In response, Telstra and the access seekers dispute a number of each other's submissions. Telstra disputes that adopting its proposed pricing would lead to financial hardship for access seekers or be inconsistent with their business and investment decisions, as the Telstra proposal is to continue the current pricing of the LSS and WLR. Telstra states that access seekers have failed to provide any evidence to support many of their contentions. Further, Telstra submits that financial information supplied by one of the access seekers demonstrates it could afford to pay Telstra's preferred level of access prices. This information is in the nature of anticipated savings in access fees and investment costs should that access seeker acquire the LSS and invest in a

DSLAM network. In any event, Telstra submits that the Commission's task is to set appropriate pricing and not to maintain access seeker's margins at a particular level.

300. Telstra also disputes that access seekers would be distracted by changes to their business operations if they were to become voice and data service providers, or that they could not if they wished supply DSL services only over the ULLS. Telstra disputes that operational support for the ULLS is of lesser quality than for the LSS or that a rebate system (should one be established as part of rebalancing) would compromise confidentiality obligations owed to access seekers.

301. Telstra points to comments made by a third party in a submission made to the 2007 LSS declaration review that becoming a full service provider over the ULLS would require incremental investment. Telstra submits that these views do not support views expressed by access seekers in the arbitration hearing.

302. Telstra also disputes that the LSS pricing that has applied to date indicates that Telstra's cost claims are likely to be excessive. Telstra states that it has been constrained by decisions made by the Commission from requiring access seekers to pay more than $9 per month, and this is why it has not sought that access seekers pay in full the higher costs Telstra now claims.

303. Telstra submits that access seekers' comparisons of its differing claims for a line cost contribution made respectively in these proceedings and in support of previous access undertakings are misguided, as differing methodologies were used to make the calculations and the earlier (lesser) claim would not recover line costs in full.

304. Telstra also submits that if the Commission considers it needs industry wide input in reaching a decision on a line cost contribution, as access seekers have suggested, then the Commission can join additional parties to the arbitration.

305. Telstra reiterates its submission that the LSS access charge will affect its decision as to whether or not to invest in a FTTN network, that line costs are a direct cost of the LSS, and that its PIEII model, as revised to respond to the Tribunal's criticisms and with the other adjustments Telstra has described, should be used to estimate line costs. [Telstra, 1/10, Part 2, pp1-3; Annexures 1-4; Telstra, 15/11, pp.1-5]

306. AAAP consider that Telstra will recover its line costs in the absence of rebalancing. AAAP consider that rebalancing would only go to the extent to which different voice and data services contribute to the recovery of those costs. AAAP consider that Telstra's legitimate interests will be satisfied in either case. In any event, AAAP considers that Telstra's direct costs are limited to the incremental costs of the service, and do not include line costs. [AAAP, 1/10, Part 2, pp.4-5]

307. AAAP dispute that the PIEII model can derive an appropriate measure of the efficient costs of the PSTN, pointing to the Australian Competition Tribunal's reluctance to accept the model, or Telstra commissioned expert reports in support of it. [AAAP, 1/10, Part 2, p6] There, the Tribunal noted that Telstra's expert had not directly tested the model in reaching his views.

308. AAAP questions the reasonableness of the line cost contribution that Telstra seeks in these proceedings, pointing to the $0.77 amount Telstra contended was appropriate in support of earlier access undertakings. Further, AAAP question Telstra's claimed costs on the basis that it has not attempted to previously charge access seekers that amount. [AAAP, 1/10, Part 2, p.2]

309. AAAP disputes that a line cost contribution would promote efficient investment in infrastructure. AAAP consider that a FTTN will likely lead to the truncation of copper loops, and make ongoing supply of the LSS unlikely. AAAP disputes that LSS charges, either generally or those to be specified in these proceedings, could possibly undermine the business case for a FTTN investment. If it had an effect, AAAP would expect that it

would be more likely to encourage than discourage such an investment. [AAAP, 1/10, Part 2, p.3]

310. AAAP also dispute that a line cost contribution would encourage service providers 'along the stepping stones of investment'. AAAP consider this would instead effectively remove the 'LSS stepping stone', at a time that progress to the 'ULLS stepping stone' is unable to be reached. Access seekers state Telstra has been requested to develop a migration path from the LSS to the ULLS, but has refused these requests. [AAAP, 1/10, Part 2, pp.3-4, 5]

311. AAAP dispute Telstra's claim that access seeker investment incentives would not be harmed by a $9 charge. AAAP state that access seekers have known since December 2005 that the Commission considered a $9 charge to be unreasonable, and have factored a reduction in LSS annual charges since this time in forming investment plans.

312. AAAP dispute that the investment data that Telstra cites is relevant, or could support Telstra's view that regulated access pricing has deterred investment. Access seekers note that the data is current to mid 2006, and are unlikely to have been influenced by the Commission's approach to ULLS and LSS pricing. Access seekers point to other factors that they consider would influence investment decisions.

313. Further, access seekers consider that higher LSS access prices will not lead to them investing in stand alone access networks. LSS access seekers state they do not have the financial resources to build a duplicate fixed-line CAN, such as by deploying a HFC network. Access seekers question whether a duplicated CAN would in any event be in the LTIE. [AAAP, 1/10, Part 1, pp.4-5]

314. Telstra responds to this submission by claiming that it is the Commission's earlier decisions on pricing that has deterred investment, and that these effects are present in the investment data Telstra provided. Telstra disputes that high ULLS or LSS charges have caused access seekers to not invest, or that factors identified by access seekers explain Optus's investment decisions. [Telstra 15/11, pp.8-9]

Commission's views

315. The Commission considered the parties' submissions made in the course of the arbitration in deciding whether, for the period covered by the FD, AAAP should make a contribution to line costs in the LSS annual charges they pay to Telstra. If the Commission did form such a view, then it would need to consider further the question of what contribution should be made.

316. For the reasons that follow, the Commission has decided that a line cost contribution should not be included in the LSS annual charges to be specified in the FD. Hence, it has not called for further submissions on this issue.

317. This is consistent with the views that the Commission reached in its recent review of the LSS declaration and associated pricing principles, and which are provided in the final report on the declaration that was published on 29 October 2007. [ACCC, *Review of the Line Sharing Service Declaration – Final Decision*, October 2007] The Commission reached its views in that public inquiry by reference to the subsection 152CR(1) criteria and information provided by Telstra and a wide cross section of other interested parties.

318. The Commission has reached its views in this determination having regard to the subsection 152CR(1) criteria and the 2007 pricing principles for the LSS under subsection 152AQA(6) of the Act. The Commission also considered the 2002 LSS pricing principles as another matter under section 152CR(2) of the Act. The Commission has also considered all the submissions of the parties. As the Commission's views expressed in its final report concerning the extension of the LSS declaration were based upon an assessment of the same criteria and principles, the Commission has also considered the findings of that final report.

319. The Commission initially sought the parties' views on the practicalities of rebalancing charges ahead of 31 December 2007 (which was the date that the Commission initially proposed to the parties for the FD to expire).

320. Telstra's submissions suggest that the LSS contribution to line costs could be implemented very quickly. This is based, in part, on Telstra's views that rebalancing is not required (as line costs are not being recovered from *line rental revenues*), and an arbitrary allocation of line costs would be appropriate. The Commission disagrees with these views.

321. Based upon Telstra's advice that WLR charges could unilaterally be varied by altering standard terms, the Commission accepts that a rebalancing of costs could be implemented in a number of weeks *following determination of how and by how much to rebalance*, and the corresponding increment and decrement to LSS and WLR charges. However, this does not mean that the rebalancing could be implemented quickly, as specifying this increment and decrement would take time.

322. The Commission also initially sought the parties' views on whether or not, under the subsection 152CR(1) criteria, a line cost contribution should be included in the LSS annual charges to apply to AAAP for the period of the FD.

323. This reflected that the Commission has not previously recognised a contribution to line costs in LSS annual charges. On those occasions when the Commission has altered its regulatory approach to access prices, it has adopted a transition path approach, so as not to harm competition or efficient investment incentives. See ACCC, *Mobile Terminating Access Service, Final Decision*, June 2004 pp 214-222; ACCC, *Final determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, pp 60-66.

324. As discussed below, having regard to the subsection 152CR(1) criteria, the Commission considers line cost contributions should not be included in LSS annual charges during the period of the FD.

325. Subsequent to receiving the parties' submissions, the Commission sought the parties' views on the possible implications for the FD of the LSS pricing principles made in October 2007. These pricing principles provide that LSS access charges are not to contribute to line costs. The pricing principles apply until 31 July 2009.

326. Having considered the parties' subsequent views, the Commission considers that it should apply the requirement in the 2007 LSS pricing principles that expressly precludes a line cost contribution in LSS annual charges for the period in which these FDs are to be in effect.

327. The Commission considers that this approach is also consistent with the 2002 LSS pricing principles, which preclude LSS annual charges contributing to line costs for so long as Telstra is recovering those costs in other charges. The Commission is satisfied that Telstra is recovering its line costs, and that this will continue at least for the period of the FDs. This is based upon Telstra's RAF returns, which demonstrate that Telstra is fully recovering its line costs from the revenues earned on the services that use the CAN as the access technology.

Consideration against subsection 152CR(1) criteria

328. The Commission considers that having regard to the subsection 152CR(1) criteria, LSS annual charges should not contribute to line costs for the period of the FD.

Paragraphs 152CR(1)(a) & 152CR(1)(b)

329. The first of these criteria concerns the promotion of the LTIE of carriage services or of services supplied by means of carriage services (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the

objective of encouraging the economically efficient use of the economically efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

330. The particular matters that the parties have raised for consideration are the likely effect of each approach on:

(i) competition in markets for carriage services, and in particular broadband/DSL services, VoIP services and PSTN access services;

(ii) efficient use of and investment in infrastructure by which services are supplied (including the access network, and DSLAMs) or by which services are capable of being supplied (including a FTTN), including the risks associated with such investment; and

(iii) legitimate commercial interests of the supplier of the service.

331. The Commission considers that introducing a contribution to line costs within the period of the FD would impede competition in downstream broadband markets. Although the parties disagree over the exact effect that would occur, such a change in approach to regulatory pricing of the LSS would require significant changes to LSS-based service providers' businesses. These business plans have developed in reliance upon the regulatory pricing principles applying to the LSS since 2002.

332. The Commission considers that this will be the case even if the change in regulatory approach results in prices that align with Telstra's charges. Again, LSS access seekers will have formed their business plans in the expectation that the Commission would act consistently with the LSS pricing principles (subject to any subsequent published views to the contrary), and so will have factored in the probability that as a result of arbitration, charges would be specified below those established by Telstra.

333. The Commission considers that with a contribution to line costs in LSS charges to apply during the period of the FD, actual or prospective LSS-based service providers will be less able to compete such as by commencing supply in additional service areas. This will be the case even if it was established that an access seeker's financial position meant that it could currently afford to maintain its current business operations and contribute to line costs. In any event, the Commission does not consider that the financial details provided by Adam demonstrate its current financial position, as Telstra has suggested in one part of its submission. These details concern cost reductions Adam anticipated when choosing to acquire the LSS from Telstra. It does not establish Adam's financial position. Further, as Telstra elsewhere notes, there is no information to suggest that Adam actually realised these cost savings.

334. LSS-based supply has to date brought benefits to end-users in relevant service areas, in particular, by supporting higher quality (ADSL2+) services.

335. Further, the manner of implementing a line cost contribution could have a disruptive effect on competition. This will be the case if it is implemented too quickly. This disruption would likely lead to a lessening of competition in markets for downstream broadband/DSL services, in particular. It will likely take the access seekers time to implement necessary changes, as they would need to consider altering input services, and retail systems, and/or winning end-user voice business. The impediment to migration of existing services from the LSS to ULLS exacerbates this. To switch between platforms, the LSS disconnection and ULLS connection cannot currently be completed in a single step. This necessitates loss of service to the end-user, and additional cost to the service provider, and makes migration to the ULLS impracticable.

336. More generally, making fundamental changes in approach to regulatory pricing principles without adequate warning and transitional arrangements would likely deter competitive entry or further investment in competitive infrastructure, in relation to the

LSS or other access services, as higher regulatory risk is perceived. The 2002 LSS pricing principles did not signal a probability that a line cost contribution would be required, or mean that competitors should have been alive to the prospect that any change in approach would take effect immediately. The current LSS pricing principles do not contemplate a line cost contribution before August 2009.

337. These competition concerns are not overcome by the possible promotion of competition in PSTN access markets that would accompany a reduction in WLR prices. Under Telstra's most recently proposed approach, no such reduction in WLR charges would occur, and hence it is unlikely that PSTN access would be promoted.

338. This is not to say that it would be appropriate to adopt a transition path when bringing current prices into line with an existing pricing principle. Adopting a transitional approach in those circumstances would defer the implementation of the existing principles without any clear countervailing benefit.

339. Nor does this mean that a line cost contribution could not be implemented in future without harming competition. However, unless adequate notice was given and LSS-based suppliers were able to arrange their businesses so as to continue to compete efficiently in the supply of downstream services then competition would be harmed.

340. Telstra has suggested that competition over the Optus HFC network could compensate for any reduction to LSS-based competition that may result. The Commission does not, however, consider that the Optus HFC network has provided a strong competitive constraint on Telstra to date, and considers its decision in this matter would be unlikely to promote the development of this possible source of competition. As Optus does not acquire the LSS, terms of access for the LSS will not have a direct influence on Optus's business or investment decisions.

341. Telstra submits that there is no technical reason why wholesale services could not be supplied over a HFC network (although vendor equipment does not yet exist to support access seeker control over the quality of those services). However, Optus does not currently supply a wholesale broadband service over the HFC network, and as cable broadband services are not declared under the Act, a service provider could not require Optus to do so. Even if in future Optus supplied a wholesale broadband service over the HFC network, it is doubted that such services would comprise a close substitute to existing LSS–based DSL services. In contrast to LSS–based DSL services, the Optus HFC network does not pass the majority of end-user premises, not all premises within 'the footprint' are connected to the network, and different customer equipment is required when supplying cable broadband services. Upgrades to the Optus HFC network may also be necessary before an equivalent quality of service could be supplied over that network.

342. Further, in those areas that can be serviced by the Optus HFC network, the Commission does not consider that the presence of two vertically-integrated networks necessarily would be sufficient to ameliorate the need for ex-ante regulation, or support a different approach to setting terms of access within those areas. For instance, as noted previously by the Commission, while Telstra retails higher-quality, ADSL2+ services over its network, Telstra has not felt compelled to respond to the presence of the Optus HFC by providing a wholesale equivalent product.

343. Similarly, while a number of fixed and mobile wireless networks are currently being deployed, these developments are still in their early stages. While it is an open question as to what extent services on these new networks will offer viable alternatives to those services provided via Telstra's copper CAN, the Commission does not consider that these emerging networks will provide strong competitive constraint over the period of the FD.

344. The Commission does not consider that this decision affects the objective of achieving any-to-any connectivity and the matters identified in paragraph 152AB(6)(a).

345. Turning to efficient investment in and use of infrastructure, the Commission firstly considers that efficient investments in, and use of the access network, and the LSS ordering system, will be made provided Telstra is making a normal, risk-adjusted, return on its capital employed.

346. Telstra contends that it is not recovering its line costs from line rental revenues, and as a result a line cost contribution in LSS annual charges is required for line costs to be recovered, and for Telstra to have incentives to invest in the CAN. Telstra's contention relies upon high line cost measures derived from its PIEII model, and does not account for revenues earned over all the Telstra services that use the CAN as the access technology.

347. The Commission does not consider that a line cost contribution is necessary to allow line costs to be fully recovered, inclusive of a normal risk-adjusted return on investment, or to provide incentives for efficient investment in Telstra's CAN. This is because Telstra is recovering its line costs and receiving returns on its CAN-based services in excess of Telstra's claimed weighted average cost of capital (WACC). However, should a line cost contribution be introduced in LSS access charges, LSS demand would likely be dampened with reductions below efficient levels in use and investment in ordering systems. This would have flow on consequences for efficient use and investment in downstream services by access seekers and Telstra.

348. By providing for a normal, risk-adjusted return on investment, the Commission has had regard to incentives for investment in infrastructure and the risks involved in undertaking this investment.

349. In reaching these views, the Commission assessed Telstra's claims against Telstra's 2006-07 RAF returns. These demonstrate that Telstra's revenues earned across the services that use the CAN as the access technology exceed allocated costs, including allocated CAN costs. The RAF returns are prepared by Telstra and rely upon Telstra's preferred WACC. They are prepared on a historical cost basis, and also a current cost basis whereby, in respect of CAN assets, the assets are re-valued by indexation. As Telstra is recovering line costs where these are measured on a historic cost basis, and even on a current cost basis, the Commission considers Telstra is more than able to recover its actual line costs, as well as the efficient forward looking line costs.

350. Telstra does not dispute that its RAF reports demonstrate it is recovering line costs across all services that use the CAN as the access technology. Telstra objects, however, to the Commission considering all CAN-based services in the analysis. Telstra submits that this analysis is contrary to the Commission's general approach to regulation, or puts Telstra at a significant cost disadvantage. However, the Commission has previously analysed Telstra's RAF reports to assess line cost recovery, and has not restricted this analysis to only end-user access revenues and costs. The Commission conducted such an analysis in its consideration of model prices for PSTN, ULLS and LCS charges in 2003, and had regard to that analysis in that and subsequent decisions. [ACCC, *Final Determination for Model Price terms and conditions of the PSTN, ULLS and LCS services*, October 2003.] This earlier analysis similarly demonstrated that Telstra was recovering its actual line costs.

351. Further, this analysis adopts Telstra's own line cost allocations between services. Reliance upon the analysis will not lead to a significant cost asymmetry between Telstra and access seekers. As Telstra acknowledges, the 'revenues foregone' by LSS charges not contributing to line costs, and hence the additional line cost to be recovered through other services, is an insignificant proportion of the costs of the CAN.

352. This is not to say that the Commission considers that unadjusted CCA reports measure TSLRIC+, or that they can be used directly in setting TSLRIC+ access charges. The Commission considers that CCA cost data will exceed TSLRIC+, because those cost data continue to reflect historic investment decisions without optimising for more efficient investments or operating procedures. Here, as Telstra is able to recover its line

costs even when measured on a CCA basis, and TSLRIC+ will fall below this level, the Commission considers that Telstra's RAF returns demonstrate that Telstra is able to recover line costs measured on a TSLRIC+ basis.

353. Also, the Commission does not consider that having regard to CCA costs in this way is at all inconsistent with its approach to estimating TSLRIC+ of a service and setting access charges in arbitration based upon TSLRIC+. When estimating TSLRIC+, accounting data, such as CCA costs, must be further assessed for relevance and efficiency before they could be adopted.

354. The Commission has relied upon Telstra's CCA RAF return to estimate the upper bound of the TSLRIC+ of the CAN, rather than Telstra's PIEII cost model. The Commission has previously explained why it does not consider that the PIEII model (as submitted by Telstra) will generate a reliable TSLRIC+ estimate of line costs across all areas. It is possible that the PIEII model, adjusted to reflect the Commission's preferred approach to the input values that can be adjusted, could be used to estimate line costs in some bands. [ACCC, *Assessment of Telstra's ULLS monthly charge undertaking—final decision*, August 2006, at pp.39-80].

355. The Tribunal also declined to rely upon the model to obtain a TSLRIC measure of Telstra's line costs. [*Re Telstra Corporation Ltd (No 3)* [2007] ACompT 3 at paragraph 366] While Telstra has made some modifications following this Tribunal decision, and has suggested that the Commission should make further changes to the version of the PIEII model that it submits in these proceedings, these changes do not overcome the Commission's concerns regarding the model's lack of transparency and the reasonableness of the various modelling assumptions used. The PIEII model continues to report cost measures significantly higher than Telstra's CCA measures, when lower unit cost measures would be expected under a TSLRIC+ model due to much greater potential for optimisation under the TSLRIC methodology.

356. Telstra has submitted before the Commission and the Tribunal that the PIEII model is reliable on the strength of expert reports that it obtained. However, as most recently noted by the Tribunal, the expert relied upon Telstra's description of the PIEII model in forming his views, and so his conclusions must be approached with caution. [*Re Telstra Corporation Ltd (No 3)* [2007] ACompT 3 at paragraphs 353, 354] The Commission does not consider that these reports overcome its stated concerns regarding the PIEII model.

357. Telstra also submits that it may not be able to continue to recover line costs from revenues earned on all services that are supplied over the CAN. Telstra acknowledges that the direct effect of whether or not LSS charges contribute to line costs would itself have little impact on Telstra's revenues, but considers it uncertain that Telstra's retail and wholesale data and voice services will continue to make sufficient contributions towards line costs.

358. However, the amount by which Telstra's CAN-based service revenues exceed costs is significant, overall revenues are steady, and strong TFP growth is reported for Telstra's fixed-line businesses. Although Telstra points to the removal of an access deficit contribution from PSTN origination and termination charges as a possible cause for fixed voice revenue declines, Telstra has continued to report large profits in its RAF returns for fixed voice services during and following the gradual removal of this access deficit contribution.

359. Should Telstra consider that fixed voice and data services may not be able to continue to contribute sufficiently to the recovery of line costs, it would be open to Telstra to increase line rental charges so that a greater proportion of line costs are recovered from these charges alone. Doing so would provide greater assurance that any such declines in other voice and data revenues that could possibly occur would not impede its ability to recover efficient, forward-looking line costs.

360. The Commission notes Telstra's claims that it is restricted by retail price control arrangements from increasing its line rental charges. The arrangements are contained in *Telstra Carrier Charges - Price Control Arrangements, Notification and Disallowance Determination No 1 of 2005* as amended. Relevantly, the arrangements include, under clause 13, a cap on the average price for a basket of services including all line rental products and PSTN call products, and caps on Telstra's basic line rental products, HomeLine Part and BusinessLine Part. There is also an obligation, under clause 19A, that Telstra's HomeLine Part and BusinessLine Part products are offered nationally on the same terms.

361. The Commission is of the view however that these price control arrangements do not prevent Telstra from making material increases to its line rental charges. In this regard, the Commission notes that:

(i) The price cap over the basket that includes line rentals and PSTN calls does not prevent rebalancing line rental and call charges, and so provides no direct constraint on line rental charges;

(ii) The CPI price cap that applies to the HomeLine Part product was set at a $5 per month premium above its then price, which has allowed it to be priced above most other residential line rentals, and this price can be increased in real terms until it 'catches up' with the cap;

(iii) The 'parity' obligation applies to currently unpopular 'Part' plans only, and so provides no direct constraint on Telstra pricing line rentals more generally;

(iv) Further, while there could be a degree of substitutability between the 'Part products' and other line rental products, it is unlikely that many customers on other line rentals would churn to the 'Part' products unless the price of those line rentals increased significantly. The HomeLine Part product was unpopular even when it was charged at a discount to other line rentals, and it has become slightly less popular since it has been priced at a premium to most other line rentals. [Telstra, 'Residential Bundled Services', quarterly reports to the ACCC]

362. In summary, the Commission considers that Telstra is able to recover its line costs, and will continue to be able to recover these costs in future. The Commission considers that this will not be affected by whether a contribution to line costs is included in the LSS annual charges to be paid by the access seekers for the period of the FD.

363. The Commission also considers consequences for efficient investment by access seekers in the DSL access multiplexer (DSLAM) infrastructure used to supply downstream DSL services. The immediate introduction of a line cost contribution in LSS annual charges, such as by rebalancing LSS and WLR charges, would have the effect of discouraging efficient investment in this infrastructure. This would flow from less certainty in regulatory approach, and perceptions of additional risk that investments may not be able to be recovered. Use and investment in downstream services would likely be below efficient levels as a result.

364. Telstra has submitted that LSS-based service providers would acquire the ULLS and continue to invest in DSLAM, or MSAN, networks should LSS access charges increase. However, the Commission considers that the current impediment to migrating services to the ULLS precludes this. That these impediments exist is confirmed in the parties' submissions made in the arbitration hearing. [Telstra 20/9, Part 3, p.9; AAAP 20/9, p.12] It is not clear whether, should this impediment be overcome in the longer term, LSS-based suppliers would move to a ULLS-based business model, as opposed to, for instance, reverting to a form of resale supply. This is due to the necessity for fundamental changes to the business models, such as would be required to migrate to the ULLS (when that option becomes available) and to supply voice services.

365. The parties also provided their views on whether ordering and fault handling arrangements for the LSS may be superior to those for the ULLS. Although there is

currently some difference in these arrangements, the Commission would not expect this to deter ULLS acquisition in the longer term.

366. The Commission notes Telstra's claims regarding investment in other broadband infrastructure, such as a FTTN, but does not consider that LSS prices, either generally or those applying to the access seekers for the period of the FD, will materially impact these investment decisions. It is unlikely that this issue will deter Telstra from continuing to invest in broadband access networks, as Telstra has invested in its cable broadband access network and ADSL access network, and commenced supply of ADSL2+ access services, since the Commission advised its approach to LSS pricing. Optus has also invested further in its HFC network in order to increase data transfer rates on the broadband services that it supplies over that network. [Optus, *Optus cable network hits top speed*, 17 December 2007]

367. Telstra has also raised for consideration whether LSS access prices influence investment by other service providers in alternative, stand-alone access networks. Telstra singles out the possible effect of lower LSS access prices within the Optus HFC footprint, implying that such prices may deter Optus from investing in upgrades to the HFC network within its existing footprint. Telstra cites the LECG report in support. For their part, access seekers advise that they would not respond to a higher LSS access charge by deploying their own stand-alone access network.

368. The Commission considers that there is no direct connection between LSS access prices and Optus's investment in its HFC network, given Optus does not acquire the LSS nor supply wholesale broadband services over its HFC. Further, it is not apparent that the Commission's regulatory approach to the LSS inhibits investment in cable networks. Telstra has itself twice upgraded its HFC networks since the Commission's decision, in December 2005, that Telstra's commercial offer price for the LSS was not reasonable.

369. In the longer term, it does not follow that the Commission's approach to LSS access prices would tend to discourage, rather than encourage, other network operators to invest in their existing access networks. The resulting increase in competition provided by LSS-based suppliers in downstream services could be expected to encourage Optus to upgrade the capability of its HFC network to match prevailing product offerings and service levels.

370. Further, the Commission does not consider that the LSS access seekers would be able to efficiently duplicate Telstra's access network at this time in any event, and hence considers that the Commission's approach to this issue for the purpose of this FD would not discourage the LSS access seekers from making efficient investments in their own access network.

371. The Commission notes the LECG report Telstra has submitted which seeks to demonstrate the relationship between European regulatory approaches and investment in alternative access networks. As the report relates to European jurisdictions, it may not necessarily be applicable to access regulation in Australia.

372. Telstra's legitimate commercial interests include its ability to recover its costs and make a normal commercial return on capital employed. As noted previously, the Commission considers that these interests will be satisfied whether or not LSS charges contribute to the recovery of line costs. Excluding a line cost contribution from LSS annual charges will not prevent Telstra from exploiting economies of scale and scope, as the resulting prices will promote demand for LSS and downstream services. As costs are largely fixed in nature, the increased demand will give rise to such economies, and Telstra's remains able to exploit these economies across its production processes. Further, the reduction in unit costs will in turn make it more likely that LSS costs will be recovered.

Paragraph 152CR(1)(b)

373. The next criterion concerns the legitimate business interests of the access provider, and the carrier’s or provider’s investment in facilities used to supply the declared service. (paragraph 152CR(1)(b)) The Commission’s views on the effect of this decision on this criterion is discussed above.

Paragraph 152CR(1)(c)

374. The third criterion is the interests of all persons who have the right to use the LSS. (paragraph 152CR(1)(c)) In considering this criterion the Commission focuses on the interests of access seekers.

375. Access seekers’ interests lie in being able to compete for the custom of end-users on the basis of their relative merits. It is in the interests of Adam, Agile, Amcom and Primus for the LSS annual charges they are to pay for the period of the FD to not include a contribution to line costs.

376. This is because such a change would likely necessitate a shift in access seeker’s business models, and that making necessary changes would divert them from conducting their businesses. The Commission considers this will be the case even where the change in approach results in the continued application of Telstra’s previous charges, as the Commission’s published approach will have informed the access seekers’ respective business plans and operations.

377. As well as the impact on their businesses of determining a higher than expected LSS charge, it would not be in these access seekers’ interests to pay the higher charge while other service providers are not required to pay similar charges. This principle is reflected in clauses in the CRAs applying between the parties, which require Telstra to offer to the access seekers the same terms that are available to other service providers as a result of their specification in FDs issued in arbitration, or in accepted access undertakings.

Paragraph 152CR(1)(d)

378. The fourth criterion is the direct cost of providing access to the declared service. (paragraph 152CR(1)(d)) These are the LSS incremental costs and possibly a contribution to the indirect costs necessary to the supply of the LSS. It calls for consideration to be given to Telstra’s ability to recover these costs. Telstra’s ability to recover the incremental costs of the LSS is discussed further below.

379. On the basis that ‘the direct cost of the LSS’ could be interpreted as including a portion of Telstra’s line costs, the Commission considers that Telstra will recover its line costs regardless of the approach taken to this issue. Again, the Commission notes that Telstra’s 2006-07 RAF reports demonstrate that Telstra is recovering the costs of the CAN from the revenues it earns on services that use the CAN as the access technology, and that this is observed either when using historic or current cost concepts. Further, the Commission considers that this will continue to be the case, given the large surplus currently observed, and the strong fixed-line productivity gains that Telstra reports.

380. Telstra submits that, under this criterion, the appropriate cost concept to use is actual costs. Using this cost concept, it is clear that Telstra is recovering its line costs in the absence of LSS charges contributing to the recovery of those costs. Telstra’s most recent RAF demonstrates that Telstra’s annual revenues on services that use the CAN as the access technology exceed annual costs, including annual CAN costs, by around $**<c-i-c>** million.

Paragraphs 152CR(1)(e) & (f)

381. The next two criteria are the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else; and the operational and technical requirements necessary for the safe and reliable operation of a carriage service, or a telecommunications network or a facility. (paragraph 152CR(1)(e)-(f)) The cost of extensions to Telstra’s ordering systems necessary to supply the LSS or ULLS have

been taken into account. The Commission does not consider that the 'operational and technical requirements' criterion materially contributes to this decision. Telstra's revenues as recorded in its RAF returns demonstrate it has more than sufficient ability to maintain the CAN to a level that ensures safe and reliable operation of the network.

Paragraph 152CR(1)(g)

382. The last criterion is the economically efficient operation of a carriage service, a telecommunications network or a facility. (paragraph 152CR(1)(g)) The Commission recognises that there is the potential for a rebalancing to lead to more efficient operation of services, as a proportion of line costs are allocated to the full range of services that make use of the line. However, the appropriate principles for, or the extent of, the rebalancing of charges that would be likely to lead to efficiency gains is unclear.

383. This is emphasised by the varying approaches that Telstra has itself adopted, including its joint production theory based approach that resulted in Telstra's then view that a relatively small contribution to line costs would improve efficiency. [ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings (confidential version)*, December 2005, p.22]

384. In these circumstances, there is the real potential for significant efficiency losses to result from introducing a line cost contribution at the levels Telstra advocates, or even below those levels. Demand for LSS and ADSL would likely be constrained below efficient levels as a result. Further, unless accompanied by offsetting reductions in line rental charges, including any line cost contribution in LSS annual charges would lead to less efficient outcomes. This is because doing so would simply further increase the surplus of revenues above cost, and further reduce demand for services supplied over the CAN below efficient levels.

385. Further, the method of implementation would have a significant effect on the economic efficiency of associated services, networks and facilities.

386. The Commission considers that the higher than expected access charges that would result from an immediate introduction of a line cost contribution, and the associated heightening of perceived risk, would impede competition, including competition in the provision of downstream DSL services. In these circumstances, Telstra would be able to set above-cost prices for its downstream services, leading to a reduction in the consumption of these services below efficient levels, and consequential allocative inefficiencies.

Summary

387. In summary, the Commission considers that introducing a line cost contribution within the LSS annual charges to be specified in the FD would be contrary to the subsection 152CR(1) criteria. Although there is the potential for allocative efficiency to be enhanced should an efficient contribution be able to be ascertained and included (and Telstra make offsetting reductions in its line rental charges), the other criteria militate against such a contribution being included in LSS annual charges to apply for the period of the FD.

388. Given these views, the Commission has determined not to further consider in these proceedings the inclusion of a contribution to line costs in LSS annual charges payable by the access seekers for the period of the FD.

389. Similarly, the Commission notes Telstra's submission that further investigation should be given to what allocation of line costs would promote efficiency. To this end, Telstra has suggested joining parties to the arbitration. However, as a result of the views that the Commission has reached after having regard to all of the criteria and the LSS pricing principles, it does not consider that it should include a line cost contribution in LSS annual charges to be specified in the FD. Therefore, the Commission considers this inquiry, and the joining of parties to the arbitration, is unnecessary.

390. Further, the Commission recently invited Telstra and other parties to provide details to support such calculations in the course of its recently concluded inquiry into the LSS declaration and pricing principles. These data were not provided, and there is nothing to suggest that these data would now be available.

391. As a result of its views on whether to include a line cost contribution, it is not necessary to here consider the parties' submissions concerning whether a line cost contribution should be averaged or de-averaged. The Commission did address this in developing the 2007 LSS pricing principles, and concluded that if a line cost contribution was recognised in future, it should be de-averaged. As compared to some other cost categories, line costs differ significantly between geographic bands. Hence, the use of averaged line costs would have a significant distortionary effect.

4.1.8 'Specific costs'

392. The term 'specific costs', in respect of the LSS, refers to the incremental cost of providing the LSS, and includes the costs associated with ordering, provisioning and qualifying a line sharing service. Relevant cost categories include IT system development and operational costs; connection costs; wholesale management costs; and indirect costs (ACCC, *Final Decision on whether or not a Line Sharing Service should be declared under Part XIC of the Trade Practices Act 1974*, August 2002, at page 85).

393. Some of these cost categories are recovered through LSS connection charges, or other charges that Telstra imposes, and so are not relevant to the calculation of LSS annual charges.

394. A number of matters have been identified as influencing the measurement of 'specific-costs' and the calculation of the access charge. The Commission had regard to the section 152CR(1) criteria, and the 2007 LSS pricing principles as required by subsection 152AQA(6) of the Act, in considering the approach to take on these matters. The Commission had regard to the 2002 LSS pricing principles as an additional matter under subsection 152CR(2) of the Act.

395. The Commission also then assessed, against the subsection 152CR(1) criteria and the 2007 (and 2002) LSS pricing principles, the LSS annual charges that would follow from the adoption of the various approaches to these particular issues.

Cost allocation

Introduction

396. Consistent with the Tribunal's views, the Commission proposed an approach to cost allocation that, firstly, pooled the 'specific costs' associated with (i) the LSS and (ii) the ULLS, and (iii) Telstra's own internal costs of a nature equivalent to the specific costs of the LSS and ULLS; and secondly, allocated this pool to a demand base including all downstream ADSL services.

397. Under this approach, the costs to pool and allocate are limited to the like-for-like incremental costs associated with:

- a Telstra internal request for line sharing (when a retail or wholesale ADSL service is requested); or
- a request for line sharing, or access to the full spectrum on the line, from an external service provider (LSS or ULLS).

398. Costs associated with the conversion of line sharing into a downstream service are not included in the cost pool to be allocated.

Parties' submissions

399. Telstra opposes 'pooling', advocating that costs should be allocated to the external supply of the LSS (with these allocations made in the same way as in Telstra's RAF returns). [Telstra 20/9, Part 3, pp. 32-35, Annexure 15]

400. Telstra submits that pooling is inconsistent with the direct cost criterion. In Telstra's view, this criterion requires that the specific costs of the LSS should be recovered solely from LSS access charges, while the pooling approach does not measure or estimate costs in such a way to permit this. [Telstra 20/9, Part 3, pp.32-33]

401. Telstra claims that the Commission's impetus for adopting the pooling approach is to reduce costs faced by competitors. Telstra submits that while this would promote entry, this is not the same as promoting competition. In order to promote competition, access seekers should pay for resources consumed in respect of the service. [Telstra 20/9, Part 3, p.33; Annexure 15]

402. Telstra considers that the pooling approach will reduce incentives for efficient investment. This is because, in Telstra's view, it amounts to basing cost allocations on profitability, thereby reducing incentives to invest in products that would be successful. Further, a lesser allocation of cost to external users of the LSS as would result from the pooling method would discourage external users of the LSS from investing in alternative access technologies. On the other hand, as the pooling approach leads to a relatively higher allocation to its own supply, Telstra considers that investment incentives will thereby be reduced for Telstra as a vertically-integrated supplier. [Telstra 20/9, Annexure 15]

403. Telstra also considers the pooling method is inconsistent with its legitimate business interests, and with the interests of all access seekers and competitors that do not acquire the LSS. [Telstra 20/9, Annexure 15]

404. Telstra also submits that the pooling approach is inconsistent with the 2002 LSS pricing principles, as the principles require LSS charges to be set at the TSLRIC+ of the specific costs of the LSS. Telstra considers the pooling approach would not result in such a measure being derived. [Telstra 20/9, Part 3, p.34]

405. Telstra acknowledges that its views conflict with the Australian Competition Tribunal's decisions on this issue. Telstra claims however that the Tribunal was fundamentally wrong in that its decisions only allow Telstra to exploit certain economies of scale and scope, when it should be able to exploit any economies of scale that arise, and is based on the premise that Telstra is able to determine the level of specific costs to be included in LSS charges. Telstra states the latter view is incorrect as Telstra is subject to the access regime under which the Commission can set access charges in arbitration. [Telstra 20/9, Part 3, p.34]

406. AAAP support pooling, and endorse the allocation of the cost pool to downstream DSL services. [AAAP 20/9, p.14]

407. In response, Telstra accepts that where competing firms use the same common infrastructure, the costs associated with that infrastructure should be allocated to each firm on an equivalent basis. Telstra contends however, that specific costs are not 'common to all firms'. Telstra also restates its views around economies of scale, efficient investment, and profitability being irrelevant to allocation. [Telstra 1/10, Part 2, pp.3-5]

408. As a consequence of its decision in the LSS declaration review, the Commission issued new pricing principles in October 2007. These expressly provide that the 'pooling approach' should be adopted. The Commission sought the parties' views on the Commission having regard to these pricing principles in making the FD.

409. Telstra objects to this aspect of the 2007 LSS pricing principles. Telstra considers that this approach is not appropriate for the reasons set out in its earlier submissions. [Telstra, 15/11 supplementary submission, p.5]

410. The access seekers did not object to the 2007 pricing principles being used. [AAAP, 15/11]

Commission's views

411. The 'pooling approach' the Commission proposed has been adopted previously. (ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings (confidential version*), December 2005, Appendix A, at pages 45 to 62).

412. It is also consistent with the reasoning of the Australian Competition Tribunal, which in finding that Telstra's then proposed approach to cost allocation was not reasonable (under section 152AH of the Act), adopted a pooling approach as the comparator. In discussing the likely effect on competition of these two approaches to cost allocation, the Tribunal stated that:

> *. . . it is helpful in the present analysis to note that spreading the LSS-specific costs over a broader range of services would be more likely to promote competition between providers of those services, subject to those costs being pooled with other specific costs relevant to the provision of DSL services in downstream markets (eg Telstra's own internal costs of a nature similar to those of providing the LSS and ULLS-specific costs). This will ensure that all providers of DSL services using Telstra's CAN would face the same non-retailing costs of providing their services. (Re Telstra Corporation Ltd ACompT 4 [2006] at [150])*

413. The Tribunal concluded that costs should be pooled, although it was not necessary for the Tribunal to express a concluded view on the demand base over which these costs should be spread. In its view, the demand base comprised at least downstream DSL services.

414. The Tribunal also considered this issue in the context of ULLS annual charges in *Re Telstra Corporation Ltd* (No 3) [2007] ACompT 3. The Tribunal again concluded that the pooling approach should be adopted, and that Telstra's proposed approach to specific costs was unreasonable. [at paragraphs 396 to 413]

415. The Commission concurs with the reasoning of the Tribunal on this issue, and does not agree with Telstra's claims that the Tribunal was in fundamental error in twice reaching the view that the pooling approach should be adopted.

416. Adopting Telstra's position on this issue would lead to a higher access charge than what was proposed as a result of the pooling approach. Telstra claims that it is this result that provides the impetus for the Commission's preference for the pooling approach. However, this is not the case. The Commission's preference for the pooling approach results from its detailed consideration of the alternative approaches assessed against the subsection 152CR(1) criteria and the LSS pricing principles. In this regard, the Commission considers that the higher charges that result from Telstra's approach cannot be supported by those criteria and principles.

417. The Commission has considered the views the parties have advanced, but remains of the view that the approach it proposed is to be preferred having regard to the subsection 152CR(1) criteria and LSS pricing principles. It follows that the Commission does not accept Telstra's view that the approach Telstra has advocated better meets the subsection 152CR(1) criteria or the LSS pricing principles.

Consideration against subsection 152CR(1) criteria

Paragraph 152CR(1)(a)

418. The first criterion concerns the promotion of the LTIE (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the objective of encouraging the economically efficient use of the economically

efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

419. The Commission considers that its proposed approach, as compared to the Telstra approach, promotes competition, by better enabling LSS and ULLS based service providers to compete on an equal footing with Telstra's wholesale and retail DSL services. As noted previously, LSS-based supply has to date brought benefits to end-users in relevant service areas, in particular, by supporting higher quality, ADSL2+, services.

420. This does not mean that Telstra and access seekers will face equivalent costs across all stages of production, as Telstra and LSS access seekers will each separately transform the LSS into downstream services, and in doing so will make investments and incur significant additional costs. It does mean, however, that for those cost categories that are within the control of Telstra, LSS access seekers will face the same level of costs as Telstra. The Commission does not accept that the access regime removes these cost categories from Telstra's control.

421. The Commission does not agree with Telstra's view that the pooling approach underestimates TSLRIC+, and hence will not promote competition, due to a potential for entry by inefficient firms. The Commission considers that the pooling approach measures the TSLRIC+ of the specific costs of the LSS, and that this measure is appropriate for use in deriving the LSS annual charges.

422. It can be noted however that Telstra does not object to pooling per se, given that the specific-cost estimate it provides for the LSS is also derived from allocations made from higher level cost pools. In Telstra's RAF returns, from which Telstra sources its claimed cost data, all costs recorded in the LSS accounts (which concern external supply of the LSS only) are drawn from a higher level cost pool and allocated by means of, for instance, relative usage measures. No costs are allocated directly to the service. What is in issue, here, is the type of 'pooling' and transparency with which the 'pooling' is undertaken.

423. As discussed subsequently in these reasons, the higher cost estimate that Telstra derives from the costs in its RAF returns reflects Telstra's approach on a number of modelling assumptions and input values that the Commission considers to be inappropriate.

424. Further, in its submissions in these proceedings, Telstra accepts that allocating costs associated with common infrastructure on an equivalent basis would promote competition. Telstra concludes however that allocating specific costs on such a basis would not promote competition.

425. It is not disputed that it is Telstra's ordering and provisioning systems and common associated infrastructure and processes that are used to provide the relevant functionality to support each of the LSS, ULLS, and the internal equivalent inputs used by Telstra's retail and wholesale divisions. That is, in each instance, Telstra systems and processes are used to receive customer orders, qualify the requested services and to arrange the necessary exchange based work. [Statement of Telstra employee (Atul Kher)]

426. The Commission considers conducting this assessment at a lower level, and considering each program that is run on Telstra's computer systems in providing this common functionality, is unnecessary. In any event, however, the Commission notes that there is overlap in the software that is used in supporting each service. Further, in respect of the LSS and wholesale ADSL services, the Commission notes that the exact same software is used for each step in the ordering and provisioning process, including the client interface (LOLO) that is used to submit orders.

427. The Commission does not consider that the approach adopted on this issue affects the objective of achieving any-to-any connectivity. Nor are the matters identified in paragraph 152AB(6)(a) affected by this decision.

428. Turning to the objective of encouraging economic efficiency in use or investment (paragraph 152AB(2)(e)), the Commission considers that the different level of unit costs that would likely be allocated to Telstra and access seekers, respectively, under Telstra's proposed approach would not represent the relative efficiency of Telstra to LSS access seekers. As noted already, the incremental costs are those of internal Telstra systems, which are passed through to access seekers, and do not reflect decisions or practices of access seekers.

429. The Commission considers that Telstra's approach would tend towards encouraging less efficient use of and investment in the infrastructure used in providing common ordering and provisioning functionality for LSS, ULLS, and DSL services. While the pooling approach ensures that access seekers and Telstra each face their share of the cost for this functionality, there is no assurance that Telstra's approach would achieve this. Under Telstra's approach, there is a likelihood that differentiated unit costs for this common functionality would be allocated to the LSS, ULLS and Telstra's DSL services. Further, as associated costs would only be met from access seekers, Telstra would have less incentive to ensure that investments that it could subsequently attribute to external supply of the LSS were necessary and implemented at efficient cost levels. Higher unit costs for external access seekers would discourage use of LSS and ULLS below efficient levels. These inefficiencies would flow through to downstream services.

430. The Commission does not accept that the pooling approach amounts to basing cost allocations on profitability, and hence does not accept that the pooling approach would thereby reduce incentives to invest in successful products.

431. Nor does the Commission accept that one or other of the approaches would be likely to promote efficient investment in access networks, or would be necessary to provide incentives for efficient investment. The Commission considers that Telstra has strong incentives to invest in its CAN given the excess of revenues to cost (inclusive of Telstra's claimed risk-adjusted WACC) that Telstra reports in its RAF returns for products supplied over the CAN. The Commission does not consider that LSS access seekers would be likely to duplicate the Telstra CAN as a result of the approach to this issue.

432. Telstra contends that the pooling approach is contrary to its legitimate commercial interests, as it would prevent Telstra from fully exploiting economies of scale and scope that would otherwise be open to it. Telstra considers that the pooling approach means that Telstra is required to share a portion of the economies it realises in providing access. Telstra's contention focuses on the exploitation of some of the economies that are realised in providing access, and ignores the other economies potentially available in transforming this access into downstream services.

433. The Commission considers that Telstra's ability to exploit economies of scale and scope over all stages of production involved in supplying services to end-users would be greater under the 'pooling approach'. This is because the pooling approach will expand demand for downstream services, as well as access, as by promoting competition it leads to the supply of downstream services that are of higher quality, of greater variety and/or more competitively priced. This increase in demand will generate strong economies of scale and scope, due to the presence of fixed costs. These economies of scale and scope will be, as the Tribunal has found, open to Telstra to exploit. [*Re Telstra Corporation Ltd (No 3)* [2007] ACompT 3 at paragraphs 409 and 410]

434. The Commission has discussed investment incentives above. The Commission considers that the pooling approach provides incentives to Telstra and LSS access

seekers to each invest in infrastructure by which downstream DSL services are supplied. By providing for a normal, risk-adjusted return on investment, the Commission has had regard for risks in making this investment.

Paragraph 152CR(1)(b)

435. The next criterion is the legitimate business interests of the provider and its investment in facilities used to provide the LSS (paragraph 152CR(1)(b)). Telstra's legitimate business interests are discussed in considering legitimate commercial interests under the first criterion. In this context, the criterion in paragraph 152CR(1)(b) involves consideration of whether Telstra will be able to recover its costs, including the direct costs associated with the LSS, and a normal risk-adjusted return on its capital employed. These matters are discussed under criterion 152CR(1)(d). The Commission considers that Telstra's legitimate business interests will be satisfied under the 'pooling approach'.

436. Telstra submits that the 'pooling approach' is inconsistent with the 'direct costs criterion', on the basis that it does not lead to specific costs being recovered only from charges paid by LSS access seekers. This submission was considered by the Tribunal in reaching its view that the pooling approach would satisfy this criterion. As the Tribunal has noted, there may be a variety of allocation methods that would enable Telstra to recover direct costs. Provided that Telstra is able to recover its direct costs under the cost allocation method, then the criterion is satisfied. [*Re Telstra Corporation Ltd* [2006] ACompT 4 at [139]] The Commission agrees that the pooling approach will permit the recovery of direct costs, as Telstra will be able to include the equivalent increment in charges for all LSS, ULLS and its downstream services supplied by means of its own use of line sharing.

Paragraph 152CR(1)(c)

437. The next criterion is the interests of all persons with rights to use the LSS (paragraph 152CR(1)(c)). The access seekers' interest lies in being able to enter markets and compete on their relative merits. The Commission considers that in this context it is access seekers' ability to enter downstream DSL markets that should be assessed. The Commission considers that its approach satisfies these interests. Telstra's proposed approach would not, as it would tend to inflate LSS access seekers' cost base above TSLRIC+ and relative to Telstra's. This would be detrimental to access seekers' interests and impede their ability to enter markets and supply downstream DSL services.

Paragraph 152CR(1)(d)

438. The next criterion is the direct costs of providing access to the LSS (paragraph 152CR(1)(d)). It is concerned with ensuring that Telstra will be able to recover its costs in providing access, either to itself or to LSS access seekers. In this context, the criterion involves consideration of whether Telstra will be able to recover its 'LSS specific costs' inclusive of a normal risk-adjusted return on its capital employed.

439. The pooling of costs associated with the external supply of the LSS and its internal provisioning could not compromise Telstra's ability to recover its direct costs of providing access to the LSS. What is involved here is ensuring that each instance of line sharing is considered in deriving the associated unit cost.

440. Further, as discussed above, the inclusion of 'ULLS-specific costs' in determining the 'LSS-specific' costs is appropriate given the commonality in underlying functionality and the use of Telstra systems involved in each case. In any event, the inclusion of 'ULLS-specific costs' 'within the pool' increases the resulting specific cost measure. And so, this could not compromise Telstra's ability to recover the direct costs of the LSS.

441. The effect of including or excluding the ULLS in the cost pool can be assessed by removing ULLS data from the Commission's cost model and observing the effect on the unit cost measure. The required changes are to delete the ULLS capital costs and demands, and to adopt the LSS operating costs and demands in preference to the ULLS operating costs and demands as the benchmark for operating costs. By making these changes to the cost model, and thereby removing the ULLS 'from the pool', a lesser cost measure is observed (of around **<c-i-c>** per service per month).

Paragraphs 152CR(1)(e) & (f)

442. The cost of extensions to Telstra's ordering systems necessary to supply the LSS or ULLS have been taken into account. (paragraph 152CR(1)(e)) The Commission does not consider that the 'operational and technical requirements' criterion materially contributes to this decision. (paragraph 152CR(1)(f))

Paragraph 152CR(1)(g)

443. The Commission has considered which approach should be favoured in terms of enabling a carriage service, telecommunications network or facility to be operated efficiently. (paragraph 152CR(1)(g)). The criterion calls for consideration to be given, in this instance, to services, networks and facilities associated with the LSS and downstream DSL services, of the access provider, the access seeker, and any other downstream service providers.

444. The Commission considers that its proposed approach strikes the best balance. It will promote competition in downstream DSL services, which will in turn encourage efficiencies in markets for these services. The Tribunal has stated that it is possible that allocative efficiency in the upstream supply of LSS would be reduced to a small extent, but that the resulting efficiencies in the downstream DSL markets would far outweigh this.

445. Turning to the LSS pricing principles, the parties accept that TSLRIC+ is the appropriate cost methodology to use. Telstra takes issue with the manner of the Commission's implementation of the TSLRIC methodology, and in particular the adoption of the pooling approach. Telstra considers that the pooling approach is inconsistent with the 2002 LSS pricing principles, and that the 2007 LSS pricing principles should not be applied insofar as they require the adoption of the pooling approach.

446. Use of the pooling approach is required by the 2007 LSS pricing principles. Further, the Commission considers that the pooling approach is also consistent with the 2002 LSS pricing principles. This is because the 'total service' will, as Telstra has noted, include both internal and external supply of the LSS, and the pooling approach better ensures that each instance of the LSS is considered in measuring the TSLRIC+.

447. As the Commission noted in first declaring the LSS in 2002, Telstra itself uses the LSS whenever it supplies a service over the higher frequency spectrum of lines that also carry a PSTN voice service. This will generally be on each occasion that Telstra supplies a retail or wholesale ADSL service:

> *. . . the Commission believes that the effective provisioning of DSL services by Telstra to itself on voice-carrying lines is sufficient for it to be considered a more established service than its trial stage would otherwise indicate*. [ACCC, 2002, p.84]

448. This view has been confirmed by expert advice obtained by the Commission that Telstra uses the same configuration at the exchange when provisioning its own ADSL services as when supplying LSS services to wholesale customers:

> *As illustrated in the (C-I-C) statement and confirmed by Telstra during the exchange visits, the jumpering and exchange activities required for a LSS service are identical to those required to activate a Telstra ADSL service, whether retail or*

wholesale. [Consultel, Final Report, February 2006, p.19; Attachment B to ACCC, April 2006]

449. Further, the pooling approach better ensures that, in determining the TSLRIC+ of the LSS and ULLS, appropriate allocations are made to the LSS and the ULLS of the Telstra infrastructure that is used to provide common supporting functionality to each.

450. To the extent, however, that it may be considered that the 2002 LSS pricing principles do not fully support 'the pooling approach', the Commission notes that in December 2005 it clearly advised interested parties that it would likely apply the 'pooling approach' in considering the specific-costs of the LSS. (ACCC, December 2005) The Commission has confirmed this intention in the course of these arbitrations and preceding arbitrations. In these circumstances, the Commission considers that there would be less reason to follow the 2002 LSS pricing principles for access charges to apply to LSS from that time.

Summary

451. In summary, the Commission considers that the pooling approach should be adopted, and this cost pool should be allocated over LSS, ULLS and downstream DSL services. The Commission considers that this approach is supported by the subsection 152CR(1) criteria and the LSS pricing principles and, as compared to Telstra's approach, better meets these considerations.

452. In determining the demand base over which to allocate the 'specific-cost pool', a key consideration has been the services that are typically supplied by means of the LSS and ULLS. The Commission has not adopted an 'all-lines' allocation[33] as it understands that, currently, the LSS and ULLS are used mainly where the end-user requires a DSL service, and that LSS and ULLS based supply is driving competition in DSL services. No party sought an 'all-lines allocation'.

Weighted average cost of capital ('WACC')

Introduction

453. The WACC is used to calculate a normal return on capital employed. In the August 2007 consultation paper, the Commission proposed using a 'post-tax vanilla' WACC ranging from around 8.5% to 9.5% for each relevant year. The Commission sought the parties' views.

454. The particular matters that the Commission drew the parties' attention to were:

- whether a mark-up should be included in the estimated WACC to reflect claimed asymmetries in the social consequences of under and over estimations
- whether the asset beta should be the asset beta observed for a business of supplying voice services on a fixed-line CAN, or some other business; and
- the date upon which the relevant observations of the risk free rate should be made for the financial years subsequent to the time to which the FD is to be backdated.

Parties' submissions

455. AAAP accept the approach to the WACC calculation that the Commission proposed. [AAAP, 20/9, p.14]

456. Telstra submits that the estimation of the WACC should be based on the approach as described in its submission, and in particular on the reports of Professor Bowman attached to its submission. In short, Telstra submits that the Commission should use a

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[33] An 'all-lines allocation' involves spreading the specific-costs over all active Telstra CAN lines, including lines used only for the supply of fixed-voice services.

WACC specific to the capital employed in Telstra's ordering and provisioning systems, and other non-network assets, relating to the LSS. In Telstra's view, the WACC of these assets is higher than for other capital Telstra has employed, such as network assets.

457. In addition, Telstra submits that in quantifying the WACC the Commission should adopt the following values and parameters:

- the actual and observed closing yields for risk-free rate as observed on the previous trading day to each of 1 July 2005, 1 July 2006 and 1 July 2007, and that these values be applied to the asset valuations on or close to those dates;
- the debt risk premium (DRP) be based on Telstra-wide DRP and not a benchmark DRP based on an A-rated benchmark bond. In addition, as with the risk free rate Telstra submits that the DRP should be measured on the trading days prior to 1 July 2005, 1 July 2006 and 1 July 2007, and that these values be applied to the asset valuations on or close to those dates;
- the market risk premium (MRP) be 7% and not 6% as adopted by the Commission in the past.

458. Telstra submits that the Commission's application of the WACC estimated in the context of PSTN OTA charges to different services supplied over the CAN is inappropriate, on the basis that the services supplied over the CAN (such as broadband) are, by definition, riskier than traditional PSTN call services.

459. Telstra also raises, as it has in other regulatory proceedings, what might be termed the 'welfare asymmetry' argument; that the social consequences of under-estimating the WACC are greater than the consequences of over-estimating it. Telstra contends that to address this welfare asymmetry the WACC should be set at 'somewhat above the normal return'. [Telstra, 20/9, Part 3, Annexure 4, paragraph 84]

Commission's views

460. Three principal issues were addressed by the parties regarding the estimation of the WACC:

(i) the appropriateness of applying the WACC of the PSTN to CAN services such as the LSS (which principally affects the estimation of the Asset Beta);

(ii) whether to provide for a 'above normal' WACC value on the basis of Telstra's 'welfare asymmetry argument'; and

(iii) when to observe particular CAPM inputs.

461. The subsequent approach to individual CAPM inputs has a lesser influence to the WACC measure.

462. In assessing the various approaches to these issues, the Commission has had regard to the 2002 and 2007 LSS pricing principles and the subsection 152CR(1) criteria.

– Appropriate asset beta

463. The Commission maintains its position that a single WACC is appropriate and that this WACC should be based on a business of providing access to a fixed-line CAN; either to itself or to other service providers.

464. Consistent with previous decisions, the Commission notes that direct observations are unavailable for different services supplied on CAN, such as the LSS. In part, this is a result of factors such as vertical integration and expansion of fixed network service providers into additional services such as mobile telephony. Consequently, the Commission's approach has been to use the observed asset beta of a business of supplying voice services on a fixed-line CAN, before the relevant business diversified into other services, such as mobiles.

465. Similarly, the Commission rejects the proposition that the asset beta, and other CAPM inputs, should be adjusted in an attempt to more precisely estimate the WACC for a business of only providing an external LSS. Consistent with previous decisions, the Commission does not consider the provision of a LSS on a stand-alone basis is a realistic business model, nor has it been presented with any evidence to suggest that the systematic risk for the underlying business of providing line-sharing (and/or other 'unbundled' access to the CAN) differs materially from the WACC of the downstream business of providing managed retail and wholesale services.

466. At the conceptual level, the Commission reaffirms its position that if a higher asset beta was to be allocated to a specific set of assets, then, in principle, this would require a compensating reduction in the WACC that is applied to other fixed-line services. Telstra discusses the desirability of applying different asset betas to different assets. However, based upon the material provided and assessed, the Commission is not satisfied that compensating adjustments to other assets could be reliably estimated to ensure that the WACC for the customer access network as a whole remains constant.

467. Finally, the Commission again raises the important practical consideration that in considering adjustments of this type to reflect the relative riskiness of different services the potential exists to introduce many sources of error. As such any change would need to be supported by robust and extensive data. The Commission does not consider that such data are available, and the submissions made to the Commission do not attempt to make such a measure of the relative riskiness of different services.

– Welfare asymmetry

468. The Commission has considered these arguments previously, and has not accepted that there is a welfare asymmetry in the social consequences of over-estimating or under-estimating the WACC. [see for instance ACCC, *Assessment of Telstra's ULLS monthly charge undertaking—final decision*, August 2006, at p.125]

469. The Commission remains of the view that an unbiased estimate of the WACC that allows for a normal rate of return on capital is appropriate given the regulatory criteria to which it must have regard.

470. Telstra presents a description of the potential cause and effects of any welfare asymmetry. Telstra contends that the consumer gains from consumption of a service are substantial and that if the WACC is set too low these gains will not be realised insofar as the necessary investment is not undertaken. Conversely, Telstra states that if the WACC is set above the normal level, the investment will always be undertaken and that the consumption gains will be realised. However, Telstra acknowledges that there will be a 'second-order' welfare effect from overpricing of these services. In a nutshell, Telstra submits that the 'second-order' effects from overpricing will be less adverse to welfare than the consumption effects of the investment not occurring in the first instance.

471. An important assumption underlying this submission is that investment decisions are effectively 'all-or-nothing': either the WACC is sufficient and all investors would consider undertaking the investment, or the WACC is collectively adjudged to be too low and no investor will consider undertaking the investment. Telstra states that this decision will be common to all investors as typically they will require external financing for major projects and, it can be inferred, that capital markets tend to hold a collective view of the expected viability of different investments.

472. The conceptual argument presented by Telstra obviously does not allow for heterogeneity in terms of risk profiles, or requirements as to returns among investors or participants in capital markets. Put another way, the assumption made here is that *all* investors – and by extension financiers in capital markets – share a common view as to an appropriate WACC for an investment project. This implies that all investors have similar expected marginal costs and revenues (as this impacts the margin necessary for

the project to be considered viable). In addition, it assumes that all potential investors have a homogenous risk profile.

473. In the Commission's view these assumptions are unlikely to reflect how investment decisions are actually made in practice. More generally, in the Commission's view, the decision as to whether or not to invest in a specific project can differ among different groups of investors, and over time, is dependant on factors such as the relative risk aversion and the expected returns required on different investments. As these are likely to differ among different investors and institutions, it is unlikely that there will always be a common view among investors and capital markets as to appropriateness of a particular return on capital. Rather investors will have different risk and return profiles for investment projects, and it is precisely the possibility to take advantage of these differences which arguably drive capital markets. For this reason, it is possible to observe in practice a combination of both high risk investments being undertaken at high rates of return, and at the same time, relatively low risk investments with correspondingly lower rates of return.

474. A separate argument raised in Telstra's submission to these proceedings is that the WACC employed by the Commission may, in fact, be part of a 'strategy by the regulator of leaning toward low rates of return' [Telstra, 20/9, Part 3, Annexure 4, paragraph 75], and that as a consequence the WACC should be increased to address this. This suggestion raises different issues to those discussed in prior regulatory decisions, where Telstra's position could be inferred to be one of accepting that the WACC estimate was properly estimated, but that the uncertainty regarding the estimation process suggested that it was prudent to allow for an above normal return.

475. The Commission has not been provided with, or is not aware of, any evidence that it has followed a strategy of leaning towards low rates of return in the estimation of the WACC. In the Commission's view, suggestions that the Commission has acted in this way, and the WACC should be adjusted to address this, are unfounded.

476. Accordingly, as in its previous assessments of this argument, the Commission has not included an increment above the estimated WACC values to reflect this argument.

– Other CAPM inputs

477. The Commission's views on the other CAPM inputs are set out below. For consistency, the Commission has altered its approach on some of these inputs to reflect its most recent decision concerning the WACC. The overall effect of these changes to slightly increase the WACC. [34] This change does not have a material effect on the resulting access charge.

478. *Risk-free rate*: For this decision, the Commission considers that the risk-free rate should be the 10 year government bond rate, averaged in the period leading up to the relevant observation date rather than a point estimate. Averaging is done to lessen volatility.

479. The observations should be taken on an ex ante basis for financial years commencing after the date from which these determinations will have effect. In this case, the average value for the period leading up to 30 June 2006 has been applied to 2006-07, and following, reflecting the Commission's decision on from when the LSS annual charge terms should apply. The Commission considers that this approach better replicates what would have occurred in an effectively competitive market for the LSS, where prices would be set proximate to when access was sought, having regard to unbiased forecasts for future periods.

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[34] ACCC, *Assessment of Telstra's ULLS monthly charge undertaking—final decision*, August 2006, p.106-7.

480. The risk free rates are sourced from Reserve Bank of Australia (Reserve Bank of Australia, *F02 Capital Market Yields - Government Bonds*, www.rba.gov.au).

481. *Market risk premium:* The Commission estimates a forward-looking market risk premium by adjusting historically observed values. Adjustments are made to reflect that markets are becoming more integrated and efficient. The Commission chose a value of six per cent, which is at the lower end of the range of historically observed values. This value is generally consistent with regulatory practice and market participant survey results.

482. *Debt ratio*: The Commission has used a target debt ratio of 40 per cent. It considers that this is reflective of the target debt ratio for a company that provides line sharing and unbundled-access to a customer access network to itself and others.

483. *Asset beta*: The asset beta used is 0.5, which is leveraged to provide an equity beta of 0.83. The basis for these values is discussed above.

484. *Debt premium*: The Commission uses a debt premium of 1.02 per cent, as it considers this is reflective of a company that provides line sharing and unbundled-access to a customer access network to itself and others. This value is consistent with recent Commission decisions.

485. *Issuance cost*: A value of 0.083 per cent is used for debt issuance, as this is considered reflective of a company that provides line sharing and unbundled-access to a customer access network to itself and others. This value is consistent with recent Commission decisions. Equity issuance costs are not included in the WACC. Should such costs be relevant, they can be considered for inclusion within the efficient cost pool as an operating-type expense.

486. *Gamma*: The possible values range from 0 to 1. The Commission has adopted a value of 0.5, as this is the midpoint of the range. The final WACC value is not materially sensitive to the value chosen.

487. *Tax rate*: The ACCC prefers an effective tax rate. However it notes that a reliable estimate of the effective tax rate may not be possible. The ACCC has used a corporate tax rate in its calculations below, as opposed to the 20 per cent tax rate used in the DFD.

– Resulting WACC values

	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**
D/V ratio	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
E/V ratio	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
Risk-free (rf)	0.0623	0.0587	0.0590	0.0483	0.0582	0.0515	0.0582	0.0582
Risk premium	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06
Asset beta	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Equity beta	0.8299	0.8301	0.8301	0.8305	0.8301	0.8304	0.8301	0.8301
Tax rate (e)	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Debt premium	0.01	0.01	0.01	0.01	0.01	0.01	0.0102	0.0102
Issuance cost	0.001	0.001	0.001	0.001	0.001	0.001	0.0008	0.0008
Gamma	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Return on equity	0.1121	0.1085	0.1088	0.0982	0.1080	0.1013	0.1080	0.1080
Return on debt	0.0733	0.0697	0.0701	0.0594	0.0692	0.0625	0.0692	0.0692
WACC (post-tax vanilla)	9.66%	9.30%	9.33%	8.26%	9.25%	8.58%	9.25%	9.25%
WACC (pre-tax exclusive of imputation benefit)	10.85%	10.45%	10.48%	9.30%	10.39%	9.65%	10.39%	10.39%

Levelisation period

Introduction

488. Levelisation refers to setting a charge to recover the costs of providing a service over a given timeframe, so that the charge does not vary from one period to the next within that timeframe. The Commission proposed that a levelisation period should be adopted commencing on 1 July 2000 and ending on 30 June 2008.

Parties' submissions

489. Telstra does not oppose levelisation, although its advocated approach to measuring the TSLRIC+ of the LSS does not adopt it. [Telstra, 20/9, Part 3, p.37; Annexure 10]

490. AAAP support levelisation, but argue for the levelisation period being extended until 2012. The access seekers consider that demand for LSS would not mature as an access service before then. [AAAP, 20/9, pp.14-15] In response, Telstra advises that it opposes the levelisation period extending beyond 30 June 2008. [Telstra 1/10, Part 2, pp5-6]

Commission's views

491. Levelisation can be appropriate for the period following the introduction of a service, or in other circumstances where demand levels are changing, and annualised costs attributed to various periods differ significantly. In these circumstances, the choice of timeframe over which to levelise costs can have a significant bearing on the per unit cost estimate.

492. This issue was considered by the Tribunal, which concluded that a levelisation period of four years for the LSS was too short. (*Re Telstra Corporation Ltd* ACompT 4 [2006] at [120]) The Commission concurs with the Tribunal's reasoning on this issue.

493. Adopting AAAP's position would likely tend towards a lower access charge, but the amount of any reduction is not known as implementing this approach would require more data.

494. The Commission remains of the view that it is appropriate to levelise over the period from 1 July 2000 to 30 June 2008.

495. While the demand for the LSS itself may not mature for some time after 30 June 2008, the approach to cost allocation that has been adopted means that it is total demand for LSS, ULLS and downstream DSL services that informs incremental unit costs. While this total demand base is likely to continue to grow beyond 30 June 2008, these services as a whole have reached a significant level of penetration, and it is likely that the rate of growth in this total demand base will reduce. In these circumstances, there would be less reason to continue to levelise costs over multiple years.

496. As a result, a single LSS annual charge has been specified for the entire period of the FD (including any backdated operation).

Efficient costs (including efficient capital costs)

Introduction

497. Under the 2007 LSS pricing principles (and as was also the case under the 2002 LSS pricing principles), it is only the efficient, forward-looking level of costs that are brought to account in setting LSS annual charges.

498. The Commission proposed in the August 2007 consultation paper to adopt the same approach to measuring efficient costs as was adopted in the arbitration of the LSS access dispute between Telstra and Chime. (ACCC, *Publication of Final Determination and associated statement of reasons – Chime/Telstra LSS access dispute*, August 2007 at pp. 38 to 41) There, the Commission adopted (for the purpose

of the arbitration) certain of Telstra's previously claimed costs as being efficiently incurred costs, but not to accept other cost claims. The Commission sought the parties' views.

499. As a result of Telstra submitting that balances drawn from Telstra's current cost accounts should be adopted as the efficient level of costs, but withholding those balances from access seekers, the Commission provided these balances to access seekers' representatives subject to confidentiality arrangements. The Commission sought supplementary submissions on the use of CCA data to set access charges.

500. As well as seeking the parties' submissions generally, the Commission asked the parties when assessing these data to consider whether:

(i) CCA balances are likely to represent efficient forward-looking costs;

(ii) whether the cost categories Telstra identified were necessary to the supply of the LSS; and

(iii) whether any of the cost categories were recovered through other charges faced by LSS access seekers.

Parties' submissions

501. Telstra submits that in the absence of an accurate bottom-up cost measure, balances drawn from Telstra's current cost accounts should be used. Telstra identifies various asset and cost categories in those accounts to which it considers the Commission should have regard, but excludes those relating to network costs and costs relating to connection groups. Network costs are excluded because, as discussed previously, Telstra's network cost estimate is drawn from the Telstra PIEII model and not from its accounting data. Connection group costs are excluded because they are recovered through other charges.

502. Telstra acknowledges that its accounts are prepared on a fully distributed cost basis rather than a TSLRIC+ methodology, but submits that its measure would still estimate TSRLIC+. [Telstra 20/9, Part 3, pp.22-23; Annexure 10] Further, while Telstra acknowledges that its cost claim has been derived from actual historic costs, it considers these costs to be forward-looking, in the sense that the costs represent actual replacement costs and are annualised. [Telstra 20/9, Part 3, pp.24, 28]

503. Telstra notes that this results in a cost measure above the level proposed by the Commission (and which was based upon cost claims that Telstra had submitted in prior regulatory proceedings). [Telstra 20/9, Part 3, pp.37-38] Telstra considers that the different level of costs is due, at least in part, to the inclusion of indirect capital costs and network operating costs within Telstra's calculations. [Telstra 20/9, Part 3, pp.30-32] On the other hand, Telstra advises the average asset life of the capital employed to supply the LSS (and hence the period over which capital costs should be depreciated), is **<c-i-c>** years, rather than the **<c-i-c>** years previously claimed. [Telstra 20/9, Part 3, Annexure 10, p.3]

504. Telstra provides estimates of its business-wide total factor productivity (TFP) over time and compared to other carriers, and also a measure of its fixed-line TFP. Telstra submits that these results support the view that its actual costs were efficiently incurred. [Telstra 20/9, Part 3, pp.24-26; Annexures 13, 14]

505. AAAP question whether the costs on which the Commission proposed to base LSS annual charges are efficient levels. [AAAP, 20/9, pp.16-17]

506. In response, AAAP complained that the basis of Telstra's CCA cost claim and the account balances were not transparent, as this level of detail had not been provided to them. AAAP dispute Telstra has demonstrated the efficiency of the CCA costs. AAAP submits that the TFP study that Telstra offered in support was prepared by a Telstra employee and the primary evidence on which the study was based was not provided.

AAAP also question the relevance of international comparisons. [AAAP, 1/10, Part 2, p.12] Telstra reiterated its view that it has demonstrated that its costs were efficiently incurred. [Telstra 1/10, part 2, p.6]

507. In response to the supplementary discussion paper, Telstra acknowledges that the Tribunal declined to accept Telstra's CCA costs as a measure of efficient forwarding looking costs. Telstra considers that the Tribunal's reasons for doing so are distinguishable. Telstra advises that in its view the Tribunal was noting that it could not be positively satisfied that Telstra had provided sufficient evidence that the CCA costs were efficient, and that its use of an annuity formula in the present arbitrations overcomes this.

508. Telstra advises that costs recovered from exchange cabling charges and Telstra Exchange Building Access charges have been removed. Telstra also submits that there is no evidence that it has included cost categories that are unnecessary to the supply of the LSS. Telstra reiterates a number of its views, including that the Commission's proposed cost model excludes relevant cost categories, and that the Commission should adopt the CCA as the best available evidence of efficient costs. [Telstra, 15/11 supplementary submission, pp.1-3]

509. Telstra disputes that it should have provided access seekers with details of the CCA balances, and restated how the balances were calculated. Telstra rejects that the CCA balances include costs of downstream services, or costs recovered through connection or disconnection charges. Telstra submits that the productivity studies were prepared by an economic consultant, and were not done in-house as access seekers claim, and provide data used in this study. [Telstra 15/11, pp.7-8]

510. AAAP submit that Telstra's CCA costs exceed the efficient forward-looking measure of the specific costs, and that any accounting data that is used in deriving the TSLRIC+ measure of these costs must be assessed for efficiency, so as to prevent allowances for inefficient practices or outdated technology. AAAP considers that the Tribunal's comments regarding whether Telstra's CCA reports provided a measure of the efficient forward-looking costs of the ULLS are applicable here. [AAAP, 15/11, pp. 3-5]

Commission's views

511. Telstra has proposed estimating the TSLRIC+ for Telstra's specific costs, and hence deriving LSS annual charges, from particular data drawn from its RAF reports that have been prepared on a current cost accounting (CCA) basis.

512. While accounting data can provide a useful starting point for deriving TSLRIC+ based access charges, the Commission has not previously accepted the use of unadjusted CCA, or historical cost data (HCA) data, as a basis for estimating the TSLRIC+ of a service.

513. Recently, the Australian Competition Tribunal cautioned against the use of CCA data concerning Telstra's Customer Access Network (CAN) for the purpose of deriving a TSLRIC measure of the ULLS:

> *381. The Commission contended that Telstra's current costs were of little or no relevance to our assessment of Telstra's proposed $30 monthly charge because current costs reflected neither the actual network costs incurred by Telstra in supplying the ULLS nor the efficient forward-looking network costs of supplying the ULLS. Telstra submitted that the current costs were a better reflection of the costs that an access seeker would incur today if it were to supply the ULLS than historic costs, as they reflected the purchase price of assets today.*
>
> *382. We do not consider that the current cost of building an existing CAN is necessarily likely to be an accurate guide to the forward-looking TSLRIC of providing the ULLS. It is not clear to us that an access provider building a network today would choose the same assets as it uses in its current network. We*

do not accept that Telstra's current cost estimate of providing the ULLS constitutes sufficient evidence as to the likely TSLRIC of providing the ULLS, nor, therefore, to the reasonableness of Telstra's ULLS access charge for the periods covered by the undertakings. [Telstra Corporation Ltd (No 3) [2007] ACompT 3]

514. The Commission notes the parties hold conflicting views as to whether these comments are applicable here. The Commission considers that the comments are applicable, and that they caution against the adoption of CCA data as a measure of efficient, forward-looking costs.

515. The Commission does not consider that the inherent limitations of CCA cost data to measure efficient forward-looking costs can be overcome simply by annualising the cost data. The annuity merely concerns how the cost pool is recovered over time; it does not adjust the quantum of the cost pool that is to be recovered, and so, does not guard against that quantum being inflated above efficient, forward-looking levels.

516. Nor does the fact that the CCA reports are prepared by Telstra under a rule that the Commission has issued (pursuant to a Ministerial direction to do so) mean that the CCA balances would represent TSLRIC+ values. Similarly, an external audit of Telstra's compliance with the rule does not provide any assurance that the resulting accounts are representative of TSLRIC+ values.

517. The Commission has reviewed the CCA data that Telstra submitted. As discussed below, the Commission does not consider that these data would support an increase to the TSLRIC+ measure above the level proposed by the Commission.

518. Telstra has also submitted that the Commission should have regard to Telstra's actual costs as well as the TSLRIC+ measure in setting LSS annual charges. The Commission does not consider that LSS annual charges should be set by reference to actual costs. This is consistent with the position long held by the Commission and Tribunal.

519. In any case, Telstra's CCA balances do not record Telstra's actual costs, as they measure costs on the premise that Telstra was required to rebuild its network and repurchase capital equipment it already owns. Unlike TSLRIC+ measures, however, it is the existing technology and capital equipment that is costed, and not necessarily the capital that would be efficiently deployed. As a result, CCA asset valuations will tend to overstate TSLRIC+ valuations. The CCA balances are also prepared on a fully distributed cost basis, and may not reflect appropriate asset and expense allocations.

520. As Telstra notes, the CCA totals are above the TSLRIC+ values used in the cost model that the Commission circulated to the parties. While Telstra points to this to question whether the values used in the model provide a reasonable TSLRIC+ measure, the opposite conclusion could equally be drawn from the discrepancy. That is, the discrepancy confirms the expected result that the CCA balances will tend to overstate TSLRIC+ measures.

521. Further support for this view arises from Telstra's CCA balances exceeding the TSLRIC+ measures that Telstra has advocated in prior regulatory proceedings. In this regard, the Commission notes that data contained in the cost model that it circulated are values that Telstra itself advocated when preparing and submitting what it then advocated as a TSLRIC+ based cost measure for specific costs, inclusive of an allowance for efficiently incurred indirect costs, in previous regulatory proceedings. In this regard, the operating and maintenance expenses, capital costs, mark-ups for indirect costs and demand data for the LSS and the ULLS that appear in the model that the Commission circulated are sourced from TSLRIC+ models annexed to the statement of Telstra employee of August 2006.

522. In discussing Telstra's CCA-based cost claim below, the Commission identifies particular aspects of Telstra's modelling that would be inappropriate to adopt, having regard to the 2007 LSS pricing principles and the section 152CR criteria. Correcting for some of these assumptions (those that can be readily varied) or input values

significantly reduces the resulting cost measure derived from Telstra's model. This provides further support for the view that Telstra's higher cost measure overstates the TSLRIC+ of the specific-costs.

523. Telstra points to TFP studies to support its view that its CCA balances are likely to represent efficient, forward-looking levels incurred. However, the Commission does not consider that a TFP study can support the proposition that these costs were efficiently incurred. TFP is the ratio of the change of outputs to inputs, generally over time, or in respect of one of Telstra's studies, across businesses. And so, high TFP growth can be influenced either by cost efficiency or scale economies from demand surges, or by reductions in inefficiencies over time, or as compared to other businesses.

524. In this instance, a business-wide TFP value, either over time or across businesses, or a TFP value relating to Telstra's fixed-line business, affords little assistance in assessing the efficiency of a relatively small capital investment, and modest O&M expenses. In these circumstances, the capital and operating costs could be of many orders of magnitude higher or lower without affecting the reported TFP measure. For instance, the CCA capital costs that Telstra identifies as attributable to the LSS represent **<c-i-c>** percent of the value of 2005-06 capital employed that is used in the study of fixed-line TFP that Telstra has provided. [**<c-i-c>**; data sourced from Telstra 20/9 Part 3 Annexure 10 page 2; Annexure 14 page 6]

525. Telstra also contends that the Commission should infer that all its costs were efficiently incurred if it reports strong TFP growth, including costs such as these that are immaterial to its TFP measures. The Commission does not accept that such an inference can reasonably be drawn.

526. Telstra further contends that its CCA based costs should be accepted as the best available measure of the TSLRIC+ of the specific costs to be recovered through LSS annual charges. The Commission does not consider that the CCA costs provide a reliable measure of the relevant TSLRIC+, or that it is the best available measure before the Commission.

527. And so, the Commission has continued to use data drawn from Telstra's previously submitted TSLRIC+ cost models, in preference to its CCA account balances, in specifying LSS annual charges in the final determination.

528. It can be noted that Telstra's claimed costs in its earlier TSLRIC+ models have also not been shown to have been efficiently incurred. And so, the possibility for this approach to also result in inefficient costs being admitted into the cost base will remain. However, the extent to which admitted costs would exceed efficient costs is much more limited under this approach, given the relatively small scale of the costs involved and that a TSLRIC+ methodology was used. And so, for the purpose of this arbitration the Commission has accepted in full Telstra's August 2006 TSLRIC+ claims.

529. Telstra has also proposed that a longer asset life should be adopted in calculating capital charges, on the basis that this is the average life of the organisational assets used to supply the LSS. Adopting this approach would tend to reduce the annual capital cost, as the asset is depreciated over a longer period.

530. Telstra advocates a longer average asset life on the basis that its claimed specific-cost asset base comprises 'organisational assets'. It would only be appropriate to adopt this asset life if Telstra's claimed asset base was to be admitted. The Commission does not consider that this would be appropriate. Even then, it is not readily apparent that Telstra's claimed asset base would have this asset life, given that they comprise, e.g., current assets and IT equipment.

531. The Commission considers that the five year asset life remains appropriate for the asset base that it has accepted. Telstra advocated a five year asset life in previous regulatory proceedings for calculating the specific costs based on this asset base. It can be noted

that rejecting this Telstra submission means that a higher unit cost, and hence access charge, will result.

532. Telstra also considers that network operating and maintenance costs should be included in the TSLRIC+ measure for LSS specific costs. These are network costs, not specific costs, and as discussed above, the Commission has decided that a contribution to network costs should not be included in LSS annual charges to be specified in this final determination.

Discussion of Telstra's CCA cost claim

533. As noted above, the Commission has decided not to adopt Telstra's CCA balances in setting LSS annual charges in this arbitration on the basis that the CCA methodology overstates TSLRIC+ values.

534. There are a number of further concerns regarding Telstra's CCA cost claim that would preclude it being adopted in these proceedings. Telstra's cost claim, and the underlying regulatory accounts have been prepared on a fully distributed cost (FDC) basis. The Commission considered alternatives to TSLRIC such as the FDC methodology in its 1997 pricing principles guide. The Commission there gave its reasons why TSLRIC is to be preferred. The Commission still maintains these views.

535. Telstra acknowledges that a FDC methodology will tend to overstate TSLRIC+. Telstra considers that FDC would only overstate TSLRIC+ by a small extent. However, the extent to which these different cost methodologies will lead to different cost measures will depend upon the particular circumstances of the costing exercise, the extent to which costs are allocated from common cost pools, and the degree of care taken in applying the cost allocators, under the FDC approach. Here, the Commission does not accept that Telstra's FDC methodology results in a TSLRIC+ measure of the LSS, or a close proxy for TSLRIC+.

536. Adopting FDC values in full would risk introducing cost categories to be recovered through LSS charges even though they have no relationship with the supply of the LSS, thereby overstating TSLRIC+. That is, the use of FDC values will tend to introduce cost categories unnecessary to the supply of the LSS, and so are outside the relevant 'increment' and/or the class of overheads to which the service should contribute. In a competitive market, a supplier of the LSS would be unable to recover a portion of these extraneous costs in LSS access charges, as other LSS suppliers would be able to offer lesser charges.

537. This risk is increased where, as is the case here, Telstra's CCA do not comprise particular assets or expenses that have been identified as being directly caused by the LSS, but rather comprise in their entirety a share of a higher level pools; and, where the CCA balances have not been subjected to further scrutiny prior to their inclusion in the present cost claim.

538. It is apparent that Telstra has not separately assessed whether each of the asset and expense categories that are present in its CCA reports for the LSS could be properly brought to account in a TSLRIC+ model for the LSS. For instance, Telstra claims interconnection costs and international settlement costs as a cost of the LSS in its CCA. Interconnection costs comprise the charges Telstra pays to other network operators for use of their networks, and international settlement costs are out-payments incurred to overseas carriers for call termination on their network. As the LSS concerns access to spectrum on Telstra lines, there is no potential for Telstra's supply of the LSS to cause these cost categories to be incurred, or for these costs to be properly attributable to the LSS. These costs would be attributable to the supply of other services that require interconnection with other operator networks.

539. Similarly, for those asset and cost categories that are potentially relevant to the supply of the LSS, adopting Telstra's claimed CCA balances would risk admitting costs at a level that are not representative of TSLRIC+ levels.

540. There are two reasons for this. The FDC approach may use allocators that do not align with incremental costs of the LSS, and/or a reasonable allocation of overheads necessary to the supply of the LSS. Again, in this case, this risk is increased given that the CCA balances for the LSS are comprised entirely by allocations made from higher-level cost pools, and not directly allocated costs.

541. The largest expense category in Telstra's CCA cost claim involves information technology expense. Telstra claims around **<c-i-c>** in IT operating expense, based upon an allocation from a higher level cost pool. Telstra provides details of the allocators used in Annexure 11 to Part 3 of its initial submission in this arbitration hearing. Further, in its submission, Telstra states that its 2005-06 cost claim could be inflated for future periods by applying the forecast growth in demand for the LSS, confirming that it is a general allocator such as relative demand or revenue for the LSS that is generally applied in its CCA.

542. The use of general allocators for IT expense is particularly problematic in respect of an access service such as the LSS. This is because in many respects the LSS will make less use of Telstra's systems and processes than the other end-to-end services that are included in the cost pool. This is because additional inputs are required to produce those other services, and relative to the LSS, those other services will make greater use of the common production inputs. Further, the initial data entry into the wholesale ordering systems is made by the access seeker, and not by Telstra staff.

543. The use of IT systems to bill the LSS, as compared to bill end-to-end services such as ADSL or fixed-voice services, provides a simple example. In order to bill the LSS, Telstra needs to identify the wholesale customer that is acquiring that LSS and the period over which the service has been supplied. To do so, it needs to extract these data from Telstra systems (the customer details and service number initially having been input by the access seeker).

544. To bill an end-to-end service, however, Telstra needs to have input much more detail regarding each customer (including each end-user customer for billing of retail services), such as the particular customer plan that has been selected, and detailed information regarding usage on the service over the relevant period. This will include total data transferred or records for each call made. To be able to generate the bill, Telstra must maintain not only these records in its systems, but also complex look-up tables regarding the amounts due for each element of the bill. Compiling the bill will require extracting data from each of these systems.

545. Accordingly, the LSS makes far less use of Telstra's billing systems, and associated information technology resources, than a simple allocator such as relative demand across all services would suggest.

546. Further support for the view that Telstra's claimed information technology expense is inflated by use of an inappropriate allocator is provided by comparing the amount claimed for information technology expense **<c-i-c>** to the value of information technology assets Telstra claims **<c-i-c>**. IT expense is the cost to operate and maintain the IT capital stock, and so there is a connection between the capital stock and O&M expense. Telstra's claim for IT expense is **<c-i-c>** times the value of the IT equipment that Telstra's CCA allocates to the LSS in 2H 2005-06. However, in that half-year and across all services, Telstra's CCA reports IT expense of around **<c-i-c>** times the value of IT equipment. The Commission considers that a lesser ratio would be applicable to the LSS, given the lesser use of Telstra's systems and lesser data entry requirements involved in respect of that service as compared to other services that Telstra supplies. And so, the Commission does not accept that efficient IT operating expenses would be in line with those reported in Telstra's CCA.

547. Telstra's CCA also includes LSS marketing expenses. Again, these represent a share of Telstra's marketing expense for a pool of services, and not expenses that have been identified as being solely caused by marketing of the LSS. Telstra supplies the LSS as a

result of the declaration of the LSS, and does not take steps to actively market the LSS. It does not for instance advertise the LSS. Again, the risk of inflated cost claims due to the use of a general allocator is increased in these circumstances. The amount claimed exceeds the cost of a LSS product manager **<c-i-c>**, which was the 'marketing' related expense that Telstra claimed in its earlier TSLRIC+ cost models. Accordingly, the Commission considers the marketing expense claimed by Telstra exceeds the TSLRIC+ value, and should be reduced to the marketing expense Telstra claimed in its own, previously submitted TSLRIC+ model.

548. Similar points can be made in respect of other expense categories that Telstra claims: each comes from a higher level allocation; the use of general allocators risks inflating the allocation made to the LSS above TSLRIC+ values; and the amounts claimed are higher than those Telstra claimed for equivalent cost categories in its earlier submitted TSLRIC+ models.

549. Secondly, as noted previously, current cost accounts have the potential to update the prices of existing equipment, including adopting costs associated with modern equivalent assets. However, as noted by the Tribunal, the claimed asset values may not represent efficient forward-looking levels. And so, the Commission considers that CCA values assigned to the cost pools will tend to overstate the asset values that would be used on a TSLRIC methodology. Further, using a fully distributed cost methodology ('FDC'), as is used in Telstra's CCA reports, risks attributing a share of assets to a service despite those assets having no connection with the supply of the service.

550. An analysis of particular asset categories in Telstra's CCA can help demonstrate the Commission's concerns regarding the adoption of CCA asset balances.

551. The Commission has made allowances for capital costs in the cost model that it distributed to the parties with the August 2007 consultation paper, including certain of the capital cost categories that Telstra includes in its indirect capital cost claim. Telstra considers that the proposed capital allowance should be increased to reflect the level of 'indirect capital costs' reported in its CCA reports.

552. 'Net (accounts) receivables', which is a current asset, is the asset category that attracts the largest balance in Telstra's CCA accounts for the LSS. It comprises around **<c-i-c>** per cent of the total asset base. As the Commission has noted in its reasons for decision published in earlier arbitrations, the balance of accounts receivable will be a factor of the level of charges, whether they are payable in advance or arrears, and diligence in collecting amounts that fall due. Further, the claimed amount is high, and is informed by the level of LSS charges that have applied (and which have given rise to a large number of access disputes). The Commission concluded there that it was not satisfied the claimed balance was reflective of forward-looking levels.

553. In addition, the Commission has since observed that Telstra's claimed balance for the LSS is a higher-level allocation, and not a direct measure of LSS accounts receivable. And so, there is the risk that the LSS is allocated a portion of accounts receivable that do not relate to the LSS. Hence inclusion of this asset category to the level Telstra claims would likely lead to access seekers being required to pay higher LSS access charges because Telstra extends credit in relation to other services. This would not be appropriate. These other services could for instance comprise the downstream services that LSS access seekers compete with Telstra to supply.

554. The Commission also notes that recognising accounts receivable would enable an access provider to recover the cost of working capital associated with services it has supplied but which are not yet paid for. In respect of LSS annual charges, however, these are predominantly paid monthly in advance. Only new LSS services that were connected since the last bill, and were therefore not billed in advance in the previous month, are billed in arrears. This means that access seekers typically pay annual charges on LSS as they use them, and hence do not require Telstra to divert working

capital in this way. On this basis, there should be little if any allowance for accounts receivable in the LSS asset base.

555. Further, while LSS connections are billed in arrears, Telstra similarly will be billed in arrears by the contractors that connect services. The contractor will have considered the consequences of this delay when agreeing the charges to apply with Telstra. Hence, revenue and efficient cost flows associated with LSS connections will largely already align.

556. And so, the Commission considers that no allowance for LSS accounts receivable should be included in calculating LSS connection charges either.

557. Further, even if an allowance was to be made for this asset category, it would not be appropriate to treat the asset category as Telstra suggests. Telstra includes this asset category along with non-current assets in the claimed asset base, and depreciates the entire amount. Treating this asset category in this way is not appropriate and inflates the associated capital charge, as this asset category does not comprise capital equipment that depreciates over time, but rather comprises a financial asset that fluctuates over time. And so, it is not appropriate to include an amount for depreciation.

558. The appropriate treatment (if any were required) would be to recognise the possible delay in revenue being received, such as by adjusting the net present value of demand. This would effectively see the WACC being applied to the revenues associated with this demand for the interim period between access being given and payment being received.

559. The Commission has assessed what effect making this adjustment could have on unit costs. Given Telstra has monthly billing, the duration for which Telstra's working capital could be diverted would be unlikely to extend beyond one month for those services billed in arrears. Even if it was assumed that all LSS demand was payable one month after the relevant month's access was given (which as noted previously would significantly overstate the actual situation given most LSS 'annual charges' are payable in advance, and most connection related costs already align with associated payments), making this adjustment to the timing of demand would not lead to a material increase in unit costs. The likely 'cost' to Telstra on a forward-looking basis would likely be less than one cent per LSS per month; and far less than Telstra's **<c-i-c>** claim would suggest.

560. Telstra's approach to other assets which it includes in its capital asset base, such as 'other current assets and related receivables', and 'land' raise similar issues, as an allowance for depreciation would not be appropriate for these asset categories either.

561. 'Long-term investments' (i.e., investments in shares, options and other financial instruments intended to be held for over twelve months) is the third largest asset balance in Telstra's CCA reports, representing around **<c-i-c>** percent of the claimed asset base. Again, the allocation is made to the LSS from a higher level pool of assets on either an 'attributable' or 'unattributable' basis.

562. There is no requirement for an LSS access provider to hold such investments, and they should not be included in an efficient forward-looking cost base. Their inclusion would effectively require LSS access seekers to pay higher access charges simply because Telstra chooses to invest in businesses that are unrelated to supplying the LSS.

563. Direct comparisons between Telstra's claimed capital allowance and the Commission's proposed capital allowance are not possible, given the fundamental difference in approach that underlie these calculations (which are discussed in detail elsewhere in these reasons). However, it can be observed that removing the two asset categories discussed above reduces Telstra's capital cost claim by around three quarters, and removing claimed depreciation for other current financial assets and land will further

reduce the annual capital charge claimed. Should these adjustments be made, the capital allowance reduces significantly.

564. Telstra has submitted that there is no evidence that its cost claim includes cost categories that are unnecessary to the supply of the LSS, or relate to downstream services. Telstra further states that its allocations are made in accordance with the RAF. The Commission does not accept that Telstra's CCA asset allocations are made with a view to ensuring that only assets necessary for the supply of the LSS are allocated to the LSS. The Commission's analysis of the particular asset categories discussed above provides support for this view.

565. Given the views that the Commission has reached regarding the exclusion of 'Net (accounts) receivables' and 'long-term investments', and the treatment of 'other current assets and related receivables' and 'land', and the corresponding effect that this has for Telstra's capital cost claim, it is not necessary to reach a finalised view on the inclusion and treatment of Telstra's other claimed cost categories.

566. The Commission notes, however, that the largest balance for these other account balances is for 'other assets not expected to be developed, utilised or received within the next twelve months and which have not already been included'. The account description provided in the RAF provides that this account could include (i) net long term inventories; (ii) provisions for future income tax benefit; and (iii) deferred research and development expenditure. As the Commission noted in its reasons for decision in previous LSS arbitrations, it is doubtful that this asset category could properly be included in a TSLRIC model for LSS 'specific-costs'.

567. The remaining asset categories comprise less than **<c-i-c>** per cent of the claim and hence are not discussed in detail here. While there could be some items within these asset categories that could fall within the TSLRIC asset base, from the Commission's review of these asset categories, it would be unlikely that it would be appropriate to admit the entire amounts that have been claimed.

568. In the November 2007 supplementary consultation paper, the Commission noted to the parties that there is the potential for claimed costs to be recovered in other charges, and that any such costs that are recovered in other charges should be excluded from the cost pool to be recovered from LSS annual charges. The Commission identified Telstra Exchange Building Access charges, and cable interconnection charges as possible examples of other charges that recover in part the claimed costs. The Commission notes Telstra's advice that costs recovered by these charges are entirely within the network cost items of its RAF reports, and so have been removed from its capital cost claims.

569. The foregoing criticisms concern Telstra's adoption of accounts developed under current cost and FDC methodologies without further assessment or adjustment, as opposed to adopting a TSLRIC methodology. The Commission is not suggesting that Telstra should undertake this additional analysis required by the TSLRIC methodology in preparing its regular RAF reports. The Commission considers that undertaking this level of analysis in each RAF report, and for each RAF service, would be impractical. Further, RAF reports are intended only to be the starting point for cost analysis, and in respect of many of the accounts, would not typically be used to establish access charges for the service. That said, should Telstra wish to revisit some of the allocations and underlying studies that have been used to populate its CCA accounts for the LSS, it is open for Telstra to do so.

Assessment of Telstra's LSS cost claim against subsection 152CR(1) criteria and 2007 LSS pricing principles

570. Adopting Telstra's cost claims in full would increase the access charge, as accepting the increased expenses and capital base would increase the access charge by more than depreciating the capital base over a much longer period would reduce it.

571. The Commission considered these claims, but after having regard to the subsection 152CR(1) criteria as discussed below, has decided to adopt the position it proposed to the parties.

Paragraph 152CR(1)(a)

572. The first criterion concerns promoting the long-term interests of end-users (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the objective of encouraging the economically efficient use of the economically efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

573. As discussed previously, the Commission considers that access charges that represent the forward-looking costs of an efficient provider best promote competition. This is because over the long run they lead to conditions which allow the access provider and access seekers to compete in downstream markets on their relative merits. The Commission considers that basing efficient costs on Telstra's previously submitted TSLRIC+ models, is more consistent with this outcome, and so would better promote competition. The Commission does not consider that the CCA balances that Telstra has submitted in these proceedings reflect forward-looking costs, as they reflect past investment decisions that are not assessed for relevance or adjusted for efficiency and have been allocated under a FDC methodology. The Commission's preference for TSLRIC methodology over other possible cost methodologies, including FDC methodologies, was first stated in the Commission's 1997 access pricing principles guide.[35]

574. An efficient access provider would incur certain costs of the type Telstra claimed when initially submitting TSLRIC+ models for the LSS; the question is whether the level of costs in those TSLRIC+ models are those of an efficient operator of the LSS. The Commission considers that Telstra's original cost claims for the LSS prepared using a TSLRIC methodology (and which were used in proposing the draft final determination), provide a reasonable estimate of the efficiently incurred costs. Although these were based on actual expenses, and there is the potential for some inefficiencies to have occurred, the limited scale of the overall cost base means that only a small downward revision would likely result if a detailed analysis of these cost categories was undertaken.

575. On the other hand, the Commission is not satisfied that all asset and expense categories that Telstra has sought to be included in the TSLRIC+ analysis would be held or incurred by an efficient provider of the LSS. Similarly, the Commission is not satisfied that the level of costs Telstra claims for those asset and expense categories that would be held are reflective of an efficient provider. The Commission came to the same conclusion in recent LSS access arbitrations,[36] In the August 2007 consultation paper, the Commission referred parties to its reasons for decision in these earlier LSS access arbitrations.

576. Accordingly, the Commission considers that its proposed approach would better promote competition.

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35 ACCC, *Access Pricing Principles – Telecommunications - a guide*', 1997

36 ACCC, *Publication of Final Determination and associated statement of reasons – Chime/Telstra LSS access dispute*, August 2007

577. The Commission does not consider that this decision affects the objective of achieving any-to-any connectivity, or that the matters identified in paragraph 152CR(6)(a) influence this issue.

578. The Commission considers that accepting Telstra's claimed costs in full is unnecessary to meet its legitimate commercial interests including its interest in exploiting economies of scale or scope. The Commission considers its proposed approach is sufficient to meet these interests, as the level of costs that Telstra incurs in respect of the LSS is less than those claimed. Further, the Commission considers that its approach to assessing efficient costs will allow for Telstra to recover its costs on a forward-looking basis, including a normal risk adjusted return. For those expenses or asset categories not admitted, Telstra can meet the associated costs regardless of the position taken here. For instance, Telstra can meet the holding costs of its claimed financial assets from associated dividends, or on a future realisation of those particular assets.

579. Further, by adopting an approach that promotes competition, demand for ADSL services will be encouraged, and this will further drive economies of scale and scope. Telstra remains able to exploit economies of scale and scope across all stages of production of its ADSL services.

580. By providing for the recovery of efficiently incurred LSS 'specific costs', inclusive of a normal, risk-adjusted return, incentives are provided for efficient investment in infrastructure, such as DSLAM networks operated by Telstra and access seekers, and LSS ordering systems. The risks associated with making these investments are also taken into account in this way.

Paragraph 152CR(1)(b)

581. The next criterion is the legitimate business interests of the provider and its investment in facilities used to provide the LSS (paragraph 152CR(1)(b)). This criterion is discussed as part of the first criterion. By providing for the recovery of efficiently incurred LSS 'specific costs', inclusive of a normal, risk-adjusted return, Telstra's legitimate commercial interests are satisfied, including its interest in recovering investments made in facilities used to provide the LSS and a risk-adjusted return on those investments.

Paragraph 152CR(1)(c)

582. The next criterion is the interests of all persons with rights to use the LSS (paragraph 152CR(1)(c)). Access seekers' interests lie in being able to compete on their relative merits. The Commission considers its approach best meets this criterion, as access seekers are not required to pay access charges based on costs that can be avoided, either currently or in the long run, or to reimburse Telstra for costs it incurs that are unrelated to the supply of the LSS. As a result, access seekers will be better able to compete on their merits against Telstra in the supply of downstream DSL services.

Paragraph 152CR(1)(d)

583. The next criterion is the direct costs of providing access to the LSS (paragraph 152CR(1)(d)). It is concerned with ensuring that Telstra will be able to recover its costs in providing access. Again, the Commission does not consider that Telstra's CCA cost claim is representative of the actual or efficient costs that Telstra incurs in providing access to the LSS. The Commission considers that the specific cost model that it circulated to the parties, which was based upon Telstra's previously submitted TSLRIC+ cost claims, provides cost measures for the LSS 'specific costs' that are representative of the costs of providing this access.

Paragraphs 152CR(1)(e) & (f)

584. The cost of extensions to Telstra's ordering systems necessary to supply the LSS or ULLS have been taken into account. (paragraph 152CR(1)(e)) The Commission does

not consider that the ‘operational and technical requirements’ criterion materially contributes to this decision. (paragraph 152CR(1)(f)).

Paragraph 152CR(1)(g)

585. The Commission has considered which approach should be favoured in terms of enabling a carriage service, telecommunications network or facility to be operated efficiently. (paragraph 152CR(1)(g)) The criterion calls for consideration to be given, in this instance, to services, networks and facilities associated with the LSS and downstream DSL services, of the access provider, the access seeker, and any other downstream service providers. The Commission considers that its proposed approach strikes the best balance. It will lead to conditions that make competition in downstream DSL services more likely, which will in turn encourage efficiencies in markets for those services.

586. Turning to the 2007 LSS pricing principles, the Commission considers that its approach best meets these principles. These principles require the use of a TSLRIC methodology. (This was also the case under the 2002 LSS pricing principles). Although Telstra considers its approach can approximate TSLRIC+ of providing the LSS, as noted above, the Commission considers that Telstra’s approach will significantly overstate TSLRIC+ of the LSS.

587. Further, Telstra’s approach is inconsistent with the requirement in the 2007 LSS pricing principles that requires the pooling and allocation of LSS and ULLS specific costs, and the equivalent costs of internal supply of these inputs. Telstra’s approach to cost allocation does not follow this course, and as a result it is unlikely that the resulting cost allocations would align with this requirement.

<u>Telstra’s internal equivalent costs</u>

Introduction

588. The Commission noted to the parties that Telstra has not made a cost claim for its internal equivalent costs, and invited Telstra to make such a claim. The Commission proposed that if Telstra was unable to provide information regarding its internal equivalent costs, these would be estimated based upon the data that had been provided in respect of the ULLS. In particular, the Commission proposed to estimate these costs on the basis that:

- the efficient internal equivalent operating (opex) costs per line that Telstra incurs are the same as those that Telstra has claimed for the ULLS.
- the efficient internal equivalent capital costs that Telstra incurs are double the capital costs that Telstra has claimed for the ULLS, and incurred at the same time as the ULLS capital costs.

Parties’ submissions

589. Telstra refers to previously supplied ADSL costs drawn from its accounting systems, and did not provide any data relating to its internal equivalent costs of line sharing. [Telstra, 20/9, Part 3, p.29] While acknowledging the potential for ADSL costs to include additional costs of converting line sharing into downstream services, Telstra claims that the difference could not be due to this alone. Telstra considers that the proposed allowance is arbitrary, and submits that the Commission should investigate this issue.

590. AAAP submit that the allowance for Telstra’s internal equivalent capital and operating costs is too high. AAAP acknowledges that there could be greater complexity in internal line sharing, as there will be a need to interface with Telstra retail and Telstra wholesale ordering systems, but considers this is unlikely to result in a build cost double of that of the ULLS system. [AAAP, 20/9, pp.16-17]

591. In response, Telstra rejects the access seeker's submissions on the basis that no evidence is adduced in support of their contentions. Telstra states that it has led evidence concerning its internal equivalent costs, and restates its contention that if there is insufficient evidence, the Commission should investigate the matter further. [Telstra 1/10, p.6]

Commission's views

592. Telstra would incur equivalent costs when it shares a line, such as in order to qualify a line, process line sharing requests, and arrange for exchange-based work to establish a line sharing arrangement. The question is what allowance would be reasonable.

593. The Commission considers that its proposed allowance is appropriate, having regard to the subsection 152CR(1) criteria and the 2007 LSS pricing principles, and taking a conservative approach to estimating the efficient forward-looking costs of internal line sharing. The Commission considers that this is preferable to the approaches advocated by Telstra and the access seekers, respectively, to increase or decrease the allowance.

594. In this regard, the Commission's allowance is calculated so as to permit Telstra to build two additional ordering and provisioning systems, of the same type and functionality that Telstra built for the ULLS, to process Telstra retail and Telstra wholesale orders for line sharing and perform associated tasks. (The Commission also includes the additional capital amount that Telstra claimed to augment its wholesale ordering and provisioning systems to also support LSS orders.)

595. The Commission considers that this allowance would tend towards overstating the efficient forward-looking cost of systems that provide the functionality necessary to establish external and internal line sharing. Should the costs of implementing the same functionality for internal line sharing as provided by the ULLS system in respect of service qualification, and provisioning was more than double the actual costs that Telstra incurred in developing the ULLS system, those costs would not have been efficiently incurred. Further, this assumes that the actual amount that Telstra spent in developing this functionality for ULLS was at an efficient level, such that it could be used as an efficient benchmark for equivalent functionality concerning internal line sharing; where there is the potential for this actual amount to have exceeded to some extent the efficient forward-looking build cost.

596. The 'ADSL costs' that Telstra claims are not the internal equivalent costs of line sharing. ADSL is the supply of a managed service over a shared line; whereas the LSS and ULLS (and internal line sharing) are services of a lower layer involving access to spectrum on copper wire. Different cost categories and elements are associated with line sharing and managed services.

597. Telstra has previously accepted in proceedings before the Tribunal that its ADSL costs are not the relevant internal equivalent costs. [*Re Telstra Corporation Ltd (No 3)* [2007] ACompT 3 at paragraph 399]

598. Nor does the Commission accept Telstra's claim that the cost of downstream ADSL services would be close to that of providing internal line sharing, given the additional technical and operational complexity of converting access to spectrum on a copper wire into an end-to-end ADSL service.

599. Further support for this view is provided from the terms of the xDSL profit and loss statement on which Telstra relies, which indicates that the retail xDSL capital expenditure data is inclusive of network expenditure, in addition to systems development. This, together with the additional functions that are required of retail systems, can be expected to explain the very significant surplus of reported retail ADSL expenditure above wholesale ADSL capital expenditure on that profit and loss statement.

600. That said, the Commission does not consider that it is appropriate to reduce the capital allowance for internal line sharing as the access seekers propose. Doing so would run a risk that the allowance may prove insufficient to recover efficient forward-looking costs, and at a practical level, it is unclear what lesser allowance than that proposed would still ensure that efficient costs were recovered.

601. The Commission notes Telstra's submission that the Commission should further investigate this issue before making this determination. However, the Commission considers that the available information is sufficient for it to form a view on the costs that would be efficiently incurred in the provisioning of internal line sharing, and that the Commission should proceed to make the final determination on the basis advised to the parties in the August 2007 consultation paper.

602. Further, the Commission notes that Telstra was invited in this arbitration hearing to provide a submission on its internal equivalent costs (as distinct to its downstream DSL costs) should it wish to do so, but did not make such a submission.

Consideration against subsection 152CR(1) criteria

Paragraph 152CR(1)(a)

603. In terms of applying the subsection 152CR(1) criteria, the first criterion concerns the long term interests of end-users. (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the objective of encouraging the economically efficient use of the economically efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

604. As discussed previously, the Commission considers that access charges that represent the forward-looking costs of an efficient provider best promote competition. This is because over the long run they lead to conditions which allow the access provider and access seekers to compete in downstream markets on their relative merits. The Commission considers that its option is more consistent with this outcome, than the parties' respective approaches, and so would better promote competition.

605. Adopting the approach Telstra implies would require LSS and ULLS-based service providers to contribute to the capital costs of Telstra's supply of competing higher layer, managed services. This outcome would lessen competition.

606. The Commission does not consider that this decision affects the objective of achieving any-to-any connectivity, or that the matters identified in paragraph 152AB(6)(a) are relevant.

607. The Commission considers that its approach satisfies Telstra's legitimate commercial interests, as it permits Telstra to recover its costs of line sharing together with a normal, risk-adjusted, return. This is because an allowance is made for Telstra's capital and operating costs when supplying line sharing to itself or access seekers.

608. Further, by adopting an approach that promotes competition and dynamic efficiencies, demand for ADSL services and cost savings will be encouraged, and this will further drive economies of scale and scope. Telstra will remain able to exploit the economies of scale and scope that it generates over all stages of production involved in supplying services to end-users.

609. Similarly, adopting the Commission's approach will promote incentives for investment in infrastructure, such as DSLAM networks and LSS ordering systems. There is the potential for the Commission's approach to provide too great an allowance for capital costs, and this could reduce investment incentives in DSLAM networks and LSS ordering systems. However, Telstra's approach would have a far greater detrimental effect on investment incentives, as it would further increase the capital allowance

above the likely efficient level. The risks associated with investment are taken into account by allowing for a risk-adjusted rate of return.

Paragraph 152CR(1)(b)

610. The next criterion is the legitimate business interests of the provider and its investment in facilities used to provide the LSS (paragraph 152CR(1)(b)). This criterion is discussed as part of the first criterion. The Commission considers that its approach is consistent with Telstra realising its legitimate business interests, such as recovering its costs of providing access and a normal, risk-adjusted return on its investment.

Paragraph 152CR(1)(c)

611. The next criterion is the interests of all persons with rights to use the LSS (paragraph 152CR(1)(c)). The access seekers' interests lie in being able to compete on their relative merits. The Commission considers its approach best meets this criterion, in the present circumstances where information is limited. Telstra's approach would necessarily lead to Telstra gaining a significant cost advantage over access seekers, as access seekers would be required to contribute to Telstra's costs of transforming line sharing into downstream services as well as funding their own transformation costs. This would be contrary to access seekers' interests.

Paragraph 152CR(1)(d)

612. The next criterion is the direct costs of providing access to the LSS (paragraph 152CR(1)(d)). It is concerned with ensuring that Telstra will be able to recover its costs in providing access, to itself or others.

613. Under the Commission's approach, Telstra will be able to recover its costs of providing access to the LSS, including a normal return on investment, from its supply of LSS, ULLS and the services that it supplies that use the LSS as an input (wholesale and retail ADSL services).

614. The additional ADSL level costs that Telstra has claimed are not the direct costs of providing access to the LSS, as they include additional expenditures incurred in supplying managed end-to-end ADSL services. Nor is an allowance for these additional ADSL level costs in LSS charges necessary to allow their recovery. Telstra will be able to recover these costs in ADSL charges. Similarly, access seekers will be required to meet their ADSL level costs from their charges for ADSL services.

Paragraphs 152CR(1)(e) & (f)

615. The cost of extensions to Telstra's ordering systems necessary to supply the LSS or ULLS have been taken into account. (paragraph 152CR(1)(e)) The Commission does not consider that the 'operational and technical requirements' criterion materially contributes to this decision. (paragraph 152CR(1)(f))

Paragraph 152CR(1)(g)

616. The Commission has considered which approach should be favoured in terms of enabling a carriage service, telecommunications network or facility to be operated efficiently. (paragraph 152CR(1)(g)) The criterion calls for consideration to be given, in this instance, to services, networks and facilities associated with the LSS and downstream DSL services, of the access provider, the access seeker, and any other downstream service providers. The Commission considers that its proposed approach strikes the best balance. It will lead to conditions that make competition in downstream DSL services more likely, which will in turn encourage efficiencies in markets for those services.

617. Turning to the LSS pricing principles, the 2007 LSS pricing principles expressly require the Telstra's internal equivalent costs should be considered. The Commission's proposed approach is consistent with this. Telstra's approach is contrary to these principles, as it seeks to incorporate a broader cost base. Telstra's proposed approach is

also contrary to the 2002 LSS pricing principles. Again, Telstra's approach would bring to account a broader cost base than appropriate for assessing the TSLRIC+ of the LSS.

Demand measures

Introduction

618. In the August 2007 discussion paper, the Commission proposed to adopt the demand measures that Telstra provided in prior regulatory proceedings which were compiled in around August 2006. These are recorded in Telstra, *Statement of Telstra employee*, 11 August 2006. The Commission proposed to source ADSL demand for 2000-01 to 2004-05 from the Commission's Snapshot of Broadband Deployment. (ACCC, *Snapshot of Broadband Deployment as at 30 June 2005*) The Commission sought the parties' views.

Parties' submissions

619. Telstra submits that the most up-to-date demand data should be used, and supplies more recent demand data (actual and forecast) for the LSS and ULLS. Slightly higher demand for LSS is reported; while demand is revised down for ULLS. These data were compiled between December 2006 and February 2007. [Telstra, 20/9, Part 3, pp.35-36, Annexure 9] Revised data for ADSL services are not supplied.

620. Telstra considers use of most up to date data is consistent with the subsection 152CR(1) criteria, as use of earlier data would send incorrect price signals to access seekers, hinder Telstra in recovering its costs, would allow access seekers an artificial advantage and would inhibit the efficient supply of the LSS and downstream services.

621. AAAP suggests using ABS data for early period ADSL demand. [AAAP, 20/9, pp.17-18]

622. Telstra objects to basing early period demand for ADSL on ABS data. [Telstra, 1/10, Part 2, p.7]

Commission's views

623. Adopting Telstra's revised demand data would tend towards a slightly higher access charge, as a fixed capital cost would be spread over lesser demand. However, adopting these data would not increase the capital unit cost enough to increase the rounded LSS annual charge. As the operating costs are largely variable, adopting Telstra's revised demand data would not be expected to influence unit operating costs. Similarly, adopting AAAP's approach of sourcing early ADSL demand data from ABS publications would be unlikely to change the rounded charge.

624. Consistent with its general approach to use ex ante TSLRIC+ modelling, the Commission considers that the earlier compiled demand data should be used in preference to Telstra's more recent data. Here, the earlier compiled demand data are more complete than this alternative data set, as they contain DSL demand data. Demand data for DSL, LSS and ULLS are required to calculate the TSLRIC+ measure.

625. Importantly, Telstra's earlier compiled data were prepared at the same time as the cost data that have been used, and so there is consistency between the entire data set that has been used to derive the TSLRIC+ measure. That is, Telstra has previously calculated and provided the operating cost associated with the earlier compiled demand data. If the more recent demand data were to be adopted, these cost data would need to be revised accordingly.

626. The parties have not claimed that the methods used to prepare the earlier data set were flawed, and no such errors are apparent to the Commission. The Commission does not agree that using Telstra's own ex ante forecast data is contrary to Telstra's legitimate interests, or compromises its ability to recover its costs. Provided that Telstra is able, on average, to prepare unbiased forecasts, it will recover its costs regardless of the

approach taken. For similar reasons, the Commission does not consider that using ex ante forecasts would lead to access seekers obtaining an artificial advantage.

627. The earlier compiled demand data are also more consistent with the data that would have been available when the parties were negotiating LSS annual charges. This is because these data were prepared more proximate to the time of the negotiations. As it would be expected in a competitive market that the parties would have been able to agree on a price for access proximate to these negotiations, and the price would have been arrived at having regard to forecast data then to hand, use of forecast data is more likely to result in access charges that would have been agreed in a competitive market. This in turn will promote efficiency.

628. The Commission has decided not to use the ABS data in this instance, as the dates at which the measures were made do not align with the other observation dates that have been used.

629. A full analysis of the differences in approach against the subsection 152CR(1) criteria or the LSS pricing principles is not provided here, as adopting one or other approach would not lead to a material change in the LSS annual charge in this instance.

Staff costs, IT O&M, and Tilting of annuity

Introduction

630. The Commission proposed adopting Telstra's approach to these issues in preparing TSLRIC+ models in prior regulatory proceedings concerning the LSS and ULLS. The Commission sought the parties' views.

Parties' submissions

631. Telstra did not comment on the staff cost allowances or IT O&M, but submits the tilt factor should be removed from the model. [Telstra, 20/9, Part 3, p.37]

632. AAAP submit that the proposed approach will tend towards higher access charges than they support, and query whether this would lead to materially higher access charges. [AAAP, 20/9, pp. 16-17] Telstra disputes that the allowance for IT O&M costs are above efficient levels. [Telstra, 1/10 Part 2, p.7]

Commission's views

633. The Commission has considered the parties' submissions and has decided to proceed as it proposed to the parties.

634. The Commission accepts that an efficient provider of the LSS would incur staff costs and IT operational and maintenance costs. While the claimed costs have not been demonstrated as efficiently incurred, the Commission has chosen to adopt the cost claim in full in this arbitration.

635. The Commission notes that Telstra does not tilt the annuity that is used in its newly-developed cost model (discussed below). However, the rounded LSS annual charge does not vary where the annuity is tilted as per Telstra's previous position, or not tilted. This can be observed by inputting '0' into relevant cells at row 3, of worksheet 'General data', in the LSS annual charges cost model that the Commission provided to the parties.

Proposed cost model

Introduction

636. The Commission provided to the parties a cost model that implemented its preliminary view. The structure of the cost model generally reflects the discrete cost models that Telstra has developed in previous regulatory proceedings for (i) 'LSS-specific costs', and (ii) 'ULLS-specific costs; but combines data from the two. The Commission sought the parties' views on use of this cost model.

Parties' submissions

637. Telstra advocates use of a newly-developed cost model, populated with its preferred approach and inputs. A written description of the model was provided. [Telstra, 20/9, Part 3, pp.22-23; Annexure 10] A copy of the spreadsheet was provided on Telstra's CD-Rom of supporting materials.

638. Telstra submits that if the Commission continues to use the model it provided to the parties, it should adjust its modelling assumption to restate the capital values each year, and should increase allowances for indirect costs in line with forecast growth in demand and should make an allowance for ADSL capital costs. [Telstra, 20/9, Part 3, pp. 28-29]

639. AAAP support the Commission's model, and submit that the actual cost estimate be used as the basis for the access charge rather than a rounded value. [AAAP 20/9, p.18]]

640. AAAP objects to Telstra's new cost model being adopted. AAAP considers the Telstra proposed model lacks detail, and the input values are not explained. AAAP also objects to Telstra preparing a model that is structured differently to the model that was proposed to the parties, as this inhibits testing the model. [AAAP, 1/10, Part 2, pp. 10-12]

Commission's views

641. The Commission has considered the parties' submissions and remains of the view that it should use the cost model that it circulated to the parties.

642. A cost model is a tool to convert assumptions and input values to a cost measure. The cost model structure proposed by the Commission in respect of LSS annual charges works, is relatively well understood, and is transparent and flexible. It adopts the structure and formulas and same level of detail that Telstra developed in submitting TSLRIC+ models to the Commission for consideration in prior regulatory proceedings, and which have subsequently been scrutinised by industry during regulatory proceedings before the Commission and the Tribunal.

643. In contrast, in its newly-developed cost model, Telstra has chosen to adopt a model structure with less detail and transparency over input data and intermediate calculations. The result is that Telstra's newly-developed model cannot be readily modified to adopt other modelling approaches, including the approach that the Commission advised the parties that it was likely to adopt in these proceedings. The Commission has reached the view that it should proceed to calculate the TSLRIC+ of the LSS 'specific-costs' in accordance with the approach outlined to the parties. As explained above, the Commission has reached this view after considering the parties' submissions and the section 152CR criteria and 2007 LSS pricing principles.

644. While as Telstra suggests particular input values in its model can be varied so as to test other scenarios, the Telstra model cannot be configured by the simple alteration in input values so as to model the approach that was outlined to the parties in the August 2007 consultation paper. Specifically, the Telstra model cannot be adjusted in this way to reflect the approach that was outlined (and which has been adopted) in respect of cost allocation and levelisation.

645. Nor can the Telstra cost model be readily adapted to reflect that approach. This would require the introduction of many additional data, the replication of existing formulas and introduction of new formulas, and would essentially result in a new model. The model's outputs would also need to be directed towards financial years rather than calendar years. The development of this third model is unnecessary in these proceedings, as the model that the Commission distributed to the parties is already configured in a way that allows the implementation of the approach that the Commission has chosen to adopt.

646. While no party suggests that the model the Commission proposed is incapable of deriving a proper measure of TSLRIC+ of the LSS specific costs, Telstra suggests amendments to input values used in the model. AAAP suggest removing the rounding up of cost measures in arriving at the LSS annual charge.

647. Adopting Telstra's suggestion, to restate capital values for each year in the model and increase allowances such as for capital costs would increase the resulting cost measure, while adopting AAAP's suggestion to remove rounding would reduce it.

648. The Commission has considered these submissions, but does not consider that either approach is reasonably open to it to adopt. Restating the capital base at the commencement of each regulatory period can assist in sending correct build-buy signals. However, in this instance, the Commission's approach to levelisation means there is a single regulatory period being considered, and it is therefore not appropriate to restate the capital values each year within that regulatory period. The Commission's views as to why it would not be appropriate to adopt Telstra's 2005-06 CCA asset and expense balances are set out earlier in these reasons.

649. Telstra has also suggested inflating its claimed 2005-06 specific cost asset base for later years in line with LSS demand growth. The Commission notes however that Telstra's suggested approach may not reflect changes in the value of the asset pool, or the relative use that line sharing makes of those assets, and so may not result in appropriate allocations. The inappropriateness for the LSS of general allocators is discussed previously.

650. In any event, the Commission considers that the asset base should be set on a bottom up analysis by reference to the timing and quantum of relevant capital expenditures, as is done in the model that it distributed to the parties, rather than based on general projections for a broader asset pool as Telstra adopts in its modelling.

651. The Commission has continued to round cost estimates to derive access charges, as this is the usual approach and recognises that it is appropriate to provide for a margin for error in conducting modelling of this nature.

<u>Assessment of parties' LSS incremental cost estimates against the subsection 152CR(1) criteria</u>

652. Telstra submits that adopting all of its preferences (and using its proposed model) will result in a measure of LSS incremental cost of between **<c-i-c>** and **<c-i-c>** per LSS per month. Different cost estimates within this range result from adopting alternative positions advanced in respect of the WACC.

653. The Commission has identified the following factors as influencing (to varying degrees) the higher cost estimate that Telstra submits: the inclusion of all claimed capital costs and expenses on a CCA (FDC) basis; a higher WACC; the approach to cost allocation; the approach to levelisation; and revised LSS and ULLS demand. These issues of principle have been discussed in detail previously in these reasons.

654. The contribution of each of Telstra's claims to the higher claimed cost cannot be calculated, as Telstra's model does not support the calculation of TSLRIC+ measures for the relevant counterfactual scenarios. While changes can be made to correct for certain input values, the output from the Telstra model will remain informed by the remainder of its modelling assumptions that cannot be readily varied, specifically as to the approach to levelisation and cost allocation.

655. While it is not possible to precisely reconcile the output of each model, the Commission has manipulated Telstra's newly-provided cost model so as to substitute preferred cost of capital related values (WACC, asset life, debt ratio, gamma, tax, and interest rate) and to reduce the claimed value of capital and expenses (top-down estimate of expenses and connection/disconnection expenses). Demand was also scaled

down slightly to test for sensitivity to delay between the LSS being consumed and charged for, and corresponding diversion of working capital.

656. Making these changes significantly reduces the 2005-06 specific cost measure reported by Telstra's model. Implementing the pooling approach and levelisation within Telstra's cost model would be expected to further reduce the cost measure obtained from that model. Accordingly, the Commission is satisfied that there are no factors that materially contribute to the difference in the competing cost measures in addition to those identified and discussed at length in these reasons.

657. Adopting the access seekers' position would result in a measure closer to $2.25. The lesser charges flow from reducing the allowance for Telstra's internal equivalent capital employed.

658. Adopting a mix of Telstra's contentions and those advanced by access seekers would result in an LSS annual charge within the range of $2.25 and $4.50 per service per month.

659. The cost estimate that is derived from the position that the Commission proposed to the parties is $2.45 (with changes made to the CAPM inputs), which is rounded to give a $2.50 annual charge.

660. The Commission considers that the overall cost measure that results from its approach is appropriate having regard to the section 152CR criteria and the 2007 LSS pricing principles. This is because this measure results from adopting the approach on each of the material issues that the Commission considers appropriate, having regard to those criteria and principles.

661. Further, the overall TSLRIC+ measure, and hence the access charge, which results from the Commission's proposed approach falls within the range of measures that could result from adopting the alternative approaches that have been advanced by the parties.

4.1.9 Commencement date, expiry date and interest

662. As noted above, the Commission has backdated the LSS annual charge and has decided to apply the charge to 31 July 2009. Interest is to be paid on resulting overpayments.

4.2 LSS 'single' connection and disconnection charges

4.2.1 Background

663. A LSS connection or disconnection can be made using:

- Telstra's standard ordering systems and processes; or,
- a managed network migration process.

664. A LSS 'single' connection or disconnection is when Telstra's standard ordering system and processes are used, and comprise all LSS connections and disconnections that occur outside of a managed network migration process.

665. Adam and Telstra are in dispute over the terms to apply to LSS 'single' connections and disconnections.

4.2.2 Current charges

666. LSS 'single' connection and disconnection charges are addressed in CRA Table 191.5 and CRA Table 191.6.

4.2.3 Prior consideration

667. LSS 'single' connection and disconnection charges have been considered by the Commission in a number of proceedings – ACCC, *Assessment of Telstra's LSS*

undertaking relating to connection and disconnection charges – final decision, April 2006; ACCC, *Statement of reasons relating to an interim determination*, 12 July 2006 (Primus dispute); *Reasons for interim determination*, 2 November 2006 (Request dispute). ACCC, *Publication of Final Determination and associated statement of reasons – Request/Telstra LSS access dispute,* August 2007.

668. Most recently, the Commission has published an extract of the final determination and associated statement of reasons in the Telstra / Request LSS arbitration that discusses how the LSS 'single' connection and disconnection charges were calculated for the purposes of that determination. (www.accc.gov.au) ACCC, *Publication of Final Determination and associated statement of reasons – Request/Telstra LSS access dispute,* August 2007.

4.2.4 Principles to apply

669. In the consultation papers, the Commission proposed to the parties that LSS 'single' connection and disconnection charges should be determined having regard to the LSS pricing principles. In the August 2007 consultation paper, the Commission initially sought the parties' submissions on the 2002 LSS pricing principles. Following the 2007 LSS pricing principles being issued, the Commission sought further submissions in November 2007 regarding the implications of these principles to the current arbitrations. The parties' submissions regarding the use of these principles are discussed previously.

670. The parties' views on use of the 2002 and 2007 LSS pricing principles are provided previously. Of significance here is Telstra's submission that 2007-08 LSS single connection and disconnection charges should be increased slightly to bring them into line with the indicative prices. [Telstra, 15/11, supplementary submission, p.2]

671. The areas of contention here are whether to specify averaged or de-averaged charges, and whether to apply those aspects of the 2007 LSS pricing principles that go into the detail of how TSLRIC+ estimates and hence charges should be calculated.

672. Adam considers the charges should be de-averaged, as use of averages distorts decisions around use and investment in infrastructure. [Adam 1/10, Part 3, p.2]

673. Adam advises that around **<c-i-c>** of its LSS are in Band 2, and applying an averaged charge will cause Adam to pay an amount of **<c-i-c>** per connection in addition to the efficient cost of making a connection in Band 2. Adam submits that an averaged charge will exceed the direct cost of making the connection and will discourage efficient investment decisions, and would impede competition as in Adam's experience, connection charges act as a differentiator in customers' decision-making. Adam considers that the potential for LSS deployment in regional and remote areas is limited, as more suitable technologies exist for those areas. [Adam, 20/9, Part 2, pp.2-4]

674. Telstra considers averaged charges would be appropriate. [Telstra, 20/9, Part 2, p.9] Telstra points to prior ACCC decisions in which averaged charges have been used on the basis that costs do not differ materially between geographic areas. Telstra submits that this approach is applicable in this case, as any difference in cost is immaterial. [Telstra, 2/10, Part 2, p.2].

675. Telstra further considers that materiality should be assessed against Adam's experienced return on investment, and that this is in the order of **<c-i-c>** per cent. [Telstra, 2/10, Part 2, p.3]

676. Telstra disputes that average charges would be inappropriate in any case. Telstra considers average charges would promote investment in regional and remote areas, and that this conclusion would hold even if the LSS was not used in those areas. Telstra, 2/10, p.2]

677. The parties submit to the effect that if charges are to be averaged, it would be appropriate to make these calculations on the basis of 80% of connections being in CBD/metropolitan areas, and the balance in regional areas. This weighting corresponds with the distribution of services in operation between Bands 1 and 2, and Band 3.

678. Consistent with the Commission's prior practice as recorded in published decisions[37], the Commission has decided to specify averaged LSS single connection and disconnection charges. The Commission referred the parties to these earlier decisions in the August 2007 consultation paper. The Commission acknowledges that there could be some difference in connection charges payable in Band 2 areas if an averaged charge approach is adopted. However, this charge is not considered material on a per connection basis, given the amount of this difference (around **<c-i-c>**) and its one-off nature. In this circumstance, the Commission considers that, as a result, the distortionary effect of averaged LSS connection and disconnection charges would not be significant. The simpler billing and administrative arrangements associated with averaged charges can support an averaged approach.

679. The Commission's views regarding materiality are informed by the scale of difference and likely frequency at which the charge is incurred. The Commission does not consider that it is necessary to consider the margins that could be available in downstream services in order to reach a view on this.

680. The Commission has revised up its 2007-08 single connection and disconnection charges as Telstra sought in its submission of November 2007 to bring them into line with the indicative prices. As to whether the additional points of detail provided in the 2007 LSS pricing principles should be applied, the Commission considers that it should apply them. These points of detail, and Telstra's objections to their application, are discussed in more detail below. The Commission remains of the view that they are appropriate as principles of general application, and further that there are no grounds for them not to be applied in the context of this access dispute.

4.2.5 Technical advice

Introduction

681. The Commission has received a number of reports (some of a draft or interim nature) concerning the connection or disconnection of the LSS. The report that is relevant to an assessment of the efficient costs of LSS 'single' connection and disconnection costs is Consultel, *Analysis of ULLS and LSS undertakings and subsequent submissions – final report*, February 2006. The Commission provided copies to the parties in August 2007.

682. In the August 2007 consultation paper, the Commission proposed to the parties that these reports should be considered, and further that Dr Brooks' views should be sought on relevant points raised in the parties' submissions. The Commission sought the parties' views on this approach.

Parties' submissions

683. Telstra submits that the Commission should not have regard to the Consultel reports. Telstra's criticism is that in its view Consultel is not qualified to advise on salary costs, and the Consultel reports have not been fully reasoned. Telstra also questions whether Dr Paul Brooks, the author of the reports, is impartial. [Telstra, 20/9, Part 2, p.3]

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[37] ACCC, *Assessment of Telstra's LSS undertaking relating to connection and disconnection charges – final decision*, April 2006; ACCC, *Publication of Final Determination and associated statement of reasons – Request/Telstra LSS access dispute*, August 2007

684. Adam does not object to the Consultel reports being relied upon, but questions some of the inputs used by Consultel in estimating back-of-house costs. [Adam, 20/9, pp. 4, 8, 10] Adam considers that Dr Brooks is suitably qualified and that his association with access seekers is less significant than Telstra has claimed.

685. Telstra also submits that Consultel's draft or interim reports should be finalised, and then circulated to the parties for comment, before they are relied upon. Adam considers that all parties have had ample opportunity to comment on the Consultel findings, and adopting Telstra's proposed process is unnecessary. Adam considers that Telstra is seeking to discount the Consultel reports simply because Telstra has been unable to refute the conclusions, and not because it hasn't had an opportunity to do so. [Adam, 1/10, Part 3, p.3]

Commission's views

686. Dr Brooks and Consultel are qualified to provide advice to the Commission regarding the systems and processes that are used to make 'single' LSS connections and disconnections. The Commission considers that Dr Brooks and Consultel are impartial, and does not consider that they could reasonably be perceived to be otherwise.

687. Further, the Commission considered that it was appropriate to proceed on the basis of the Consultel reports, including those described as of a draft or interim nature. The parties had the opportunity to comment on these reports.

688. Accordingly, the Commission has had regard to the Consultel reports in reaching its decision.

4.2.6 Assessment of efficient costs

Introduction

689. There are a number of distinct cost categories that are relevant to LSS connections and disconnections.

- 'Back-of-house' costs
- Jumpering, travel, vehicle, tool and material (copper pair) costs
- Indirect costs

'Back of house' costs

Introduction

690. Telstra staff and systems perform back-of-house tasks. Costs associated with the following Telstra workgroups and processes are considered within this category:

- Wholesale customer service group (WCSG)
- Data activation centre (DAC)
- Integrated deployment solution centre (IDS)

691. However, costs associated with Telstra's wholesale customer front of house activities are recovered through LSS annual charges.

692. Relevant costs are those incurred by Telstra in providing manual service qualifications, validating point of interconnection (POI) data and responding to faults in POI cables, in respect of connecting or disconnecting the LSS.

693. In the August 2007 consultation paper, the Commission proposed to generally adopt the approach discussed in ACCC, *Assessment of Telstra's LSS undertaking relating to connection and disconnection charges – final decision, April 2006*, pp. 37-43. These costs were also discussed in Consultel, *Analysis of ULLS and LSS undertakings and subsequent submissions – final report*, February 2006, pp. 30-38 and pp 56-57.

694. This approach results in an allowance of around **<c-i-c>** for back-of-house costs associated with LSS 'single' connections, and around **<c-i-c>** for LSS 'single' disconnections.

695. The Commission sought the parties' views.

Parties' submissions

696. Telstra did not object to the Commission's proposed allowance for back-of-house costs, although it noted that in its view some of the values used in calculating the allowance are quite low. [Telstra, 20/9, Part 2, pp.4, 7]

697. Adam submits that wholesale front-of-house costs should be excluded to avoid double-recovery of them. Adam also submits that allowances for both the DAC and IDS workgroups are too high. Adam submits that these allowances should reflect salary levels reported in an industry wide salary survey for customer service representatives.

698. Adam also considers the time allowed for DAC tasks (**<c-i-c>** minutes) is too high, as the Consultel reports would support an allowance of 3 minutes. [Adam, 20/9, pp.8, 10] Telstra considers the same Consultel report supports an allowance of between 4 and 5 minutes for the DAC workgroup. [Telstra, 2/10, Part 2, p.7]

699. Telstra disputes that the surveyed customer service salary rates are appropriate, as in its view the skill sets do not align with those required of Telstra's DAC and IDS workgroups. Telstra states these workgroups require specialised knowledge of Telstra provisioning databases, or technical type skills and experience, respectively. Telstra also states that the survey rates of pay appear to understate salary uplifts for overheads, and that further, higher cost, job classifications should be considered in calculating the survey's average customer representative salary cost.

700. Telstra also makes submissions around whether an allowance should be made for DAC involvement in manual service qualification testing. Telstra states that an average allowance of **<c-i-c>** minute has been recognised as reflective of efficient practice. [Telstra, 2/10, Part 2, pp. 6-8]

Commission's views

701. The Commission has considered the parties' submissions, and has determined to maintain its estimates of efficient back-of-house costs that were proposed to the parties.

702. The Commission has not made an allowance for wholesale front-of-house costs, as these costs have been recognised in the cost pool to be recovered through LSS annual charges.

703. As a result, the allowance for categories included in back-of house costs have been calculated as follows:

- Efficient DAC related costs are derived by applying an hourly salary cost of $60/hr to the upper bound of the range of average times (2.5 – 4 minutes) an efficient operator would require to perform the DAC tasks per LSS connection. (Consultel, *Analysis of ULLS and LSS undertakings and subsequent submissions – final report*, February 2006, pp. 34-35)

- Efficient IDS related costs are derived by estimating the quantum of IDS staff costs that would be avoided if the IDS did not perform tasks relating to LSS tickets of work (TOW) i.e. LSS connections or disconnections. Avoided IDS staff costs are estimated by, firstly, multiplying (the percentage of LSS TOWs to total TOWs considered by IDS group) by total IDS staff numbers **<c-i-c>**. This gives the number of IDS staff positions **<c-i-c>** that would not be required if the IDS group did not consider LSS TOWs. Secondly, the annual associated staff cost is calculated by applying to this number of staff positions an annual salary cost of $80,000. Finally, IDS cost per LSS TOW is calculated by dividing by annual LSS

TOWs **<c-i-c>**. (Consultel, Consultel, *Analysis of ULLS and LSS undertakings and subsequent submissions – final report*, February 2006, pp 34-35)

704. Adopting the position advocated by Adam would have reduced the allowance for back-of-house costs below these levels by around **<c-i-c>** per connection. The Commission has assessed its proposed approach and that advocated by Adam against the subsection 152CR(1) criteria and 2007 LSS pricing principles.

705. In terms of the promotion of competition, Adam's position would be preferable if this better reflects the forward-looking, efficient cost of performing these tasks.

706. The Commission acknowledges that the salary costs that Telstra claims for the DAC and IDS are above the survey's reported average customer service salary levels, and that this would remain the case if some increases in uplifts and the average salary figures were made in response to Telstra's comments.

707. However, the Commission is not satisfied that using the salary costs reported in the industry survey would themselves be a suitable benchmark for efficient forward-looking costs, given that the customer service groups of survey participants will not all be involved in performing the same tasks to the DAC and IDS.

708. Further, the information before the Commission suggests that similar back-of-house systems and processes are used for both LSS and downstream DSL connections, and hence LSS access seekers and Telstra would currently face a similar cost base.

709. In these circumstances, the Commission did not consider that the efficient, forward-looking cost base would be in line with Adam's submissions.

710. The Commission has considered the parties' claims around the average DAC allowance that the Consultel February 2006 report would support. The Consultel report identifies three discrete tasks that would require DAC involvement, as follows:

- Manual service qualification testing (1 minute)
- Voice attenuation checks (30 seconds)
- Solving technician identified problems (1 – 2 minutes)

711. The total of these allowances is 2.5 – 3.5 minutes. Consultel concludes in a subsequent report that the allowance may be as much as four minutes.

712. The Commission accepts Consultel's analysis, and considers that this supports a finding of DAC involvement requiring on average between 2.5 and 4 minutes per LSS connection. The Commission considers that in choosing a point estimate in this range, on balance a conservative approach should in this instance be adopted, and four minutes allowed. In any event, the differences in charges that would result from the values used by the Commission and midpoint values are not significant, given the amount involved (around a $0.40 reduction is observed when 3 minutes is substituted into the LSS singles connection cost model) and the one off nature of the charge.

713. For similar reasons, the Commission considers that adopting Adam's position would not better encourage more efficient use of and investment in infrastructure, the efficient supply of the LSS and downstream services, or is necessary to satisfy access seeker's interests in competing on their merits. On the other hand, adopting this approach would tend to compromise Telstra's legitimate interests, including its ability to recover direct costs, to the extent that Telstra could not attain salary and on costs for IDS and DAC staff, at the levels advocated by Adam.

714. Finally, the Commission notes that adopting Adam's approach would be contrary to the 2007 LSS pricing principles, in that adopting this approach would lead to charges being specified that differed to the indicative prices.

Jumpering, travel, vehicle and tool costs; Materials costs; Mark-up for indirect costs

715. In practice, Telstra currently uses a mix of third party contractors and its own staff to perform the exchange-based work necessary to connect and disconnect the LSS.

716. In the August 2007 consultation paper, the Commission proposed to the parties that it should assess efficient jumpering, travel, vehicle and tool costs based upon the charges of Telstra's contractors that connect ADSL services. The Commission proposed that this assessment should not be based upon cost measures that Telstra has modelled where it uses its own staff.

717. The Commission proposed that no extra amount should be allowed for the cost of materials (i.e., the cost of copper pairs used to connect points on the MDF), as contractors supply the materials necessary to connect the LSS. No allowance was made for materials in disconnection costs, as no cable is required.

718. The Commission proposed a mark-up of 10 percent on third party contractor rates to cover indirect costs such as contract management costs, in preference to Telstra's previously claimed mark-up of **<c-i-c>** percent. This reflected the view that when using third party contractors, Telstra will avoid the indirect cost categories that comprise its claimed mark-up. Further, efficiently incurred contract management costs would not represent a significant component of per LSS connection costs.

719. The Commission proposed that although it would be simpler to remove jumpers than connect them, jumpering and associated costs of disconnecting a LSS should be taken to be the same as for connecting a LSS.

720. The Commission sought the parties' views.

– Jumpering etc

721. *Blending*: Telstra submits that the Commission's proposed approach could be adopted for connections and disconnections that contractors perform, and supplies details of the rates that have been agreed for particular periods with contractors. However, a mix of own staff and contracted-labour is used to connect services across Telstra's fixed-line network. Telstra submits that LSS 'single' connection and disconnection charges should be based upon the cost of this 'blended' workforce. [Telstra, 20/9, Part 2, pp.4-6]

722. Telstra advises that for 2006-07 and following, contractors have made around **<c-i-c>** per cent of all connections on Telstra's fixed-line network. Telstra advises that use of a blended workforce is a commercial necessity, as contractors cannot perform all connections as required. Further, in Telstra's view, there are practical reasons why contractors will not be able to be used for all exchange-based work. [Telstra, 20/9, Part 2, pp.4-5]

723. In Telstra's view, the cost associated with a contractor-made connection is much less than the cost for a Telstra-made connection. As a result 'blending' results in a higher charge. [Telstra, 20/9, Part 2, pp.4-6, Annexure B] Telstra submits that the best available measure of its efficient costs should be used. [Telstra, 2/10, Part 2, p.22]

724. In the alternative, Telstra submits that it 'reserves the right' to connect LSS using only contractors willing to work for the amounts proposed to the parties. [Telstra, 20/9, Part 2, p.9]

725. Telstra acknowledges that the 2007 LSS pricing principles do not support 'blending', but submits that the Commission should not apply this aspect of these principles in this arbitration. Telstra considers that use of a 'blended workforce' will remain a commercial necessity in the long run, and that this supports blending being used. Telstra also submits that the Commission's allowance for escalation in future contractor rates may not be sufficient to cover rates subsequently agreed with contractors. [Telstra, 15/11, supplementary submission, pp.1-2]

726. Adam submits that contractor charges can provide a reliable measure of the efficient level for these cost categories, including those made by Telstra staff. In Adam's view, this benchmark should be applied to all connections, including those performed by Telstra staff. Adam considers that doing this may remove the need to weight individual costs for 'contractor-made connections' and 'remaining connections'. [Adam, 20/9, Part 2, p.5]

727. Adam disputes that Telstra cannot use contractors to make a greater share of connections than has been the case, and restates its view that Telstra's claimed costs to connect services using own staff are inefficient, and associated overheads are very high. In these circumstances, Adam considers accepting Telstra's blended costs would necessarily overstate forward-looking efficient costs. Further, Adam points to submissions Telstra has made in other regulatory proceedings where it advocates the use of efficient cost pricing, and considers Telstra's arguments in favour of blending to be contrary to these prior submissions. [Adam, 1/10, Part 3, pp.4-6]

728. Adam states that it is indifferent to whether contractors, or Telstra staff, make its LSS connections. It notes that, as the average contractor agreed rates are used in deriving the proposed charges, the proposed charges would overall permit the recovery of contractor charges. [Adam, 1/10, Part 3, p.14]

729. *Acceptance of contractor rates as an efficient benchmark*: However, Adam questions whether the contractors were asked to quote on the basis of efficient work practices, and in particular, on the basis that a high percentage of LSS work orders could be batched with other work orders at the exchange. If not, Adam considers that the resulting contractor charges would still overstate the efficient level of the underlying cost categories. Adam considers that, for a variety of reasons, there is added potential for the majority of its LSS work orders in CBD/metro areas to be batched with other work orders. [Adam, 20/9, Part 2, pp. 6-8]

730. Telstra states that there is little potential for further batching to occur above that already reflected in contractor charges, as its Connect dispatch system already achieves a high level of batching. Telstra points to the weighted average of contractor charges as demonstrating that a high level of batching is occurring. [Telstra, 2/10, Part 2, p.4] Telstra describes Adam's comments on the potential to batch its LSS connections to a greater degree as speculative. [Telstra, 2/10, Part 2, p.5]

731. Adam also queries whether Telstra's actual contractor charges for 2007-08 should be accepted in full as an efficient measure, on the basis that the rates are higher than Telstra anticipated to apply in 2007-08. [Adam, 1/10, Part 3, p.7]

732. *Jumper over extra charge*: Telstra supplies details of the relevant costs it faced in 2006-07, and those currently applying, when contractors perform LSS or DSL connections. Included are details of a 'jumper-over extra charge', for connections that involve running a jumper between a second main distribution frame. [Telstra, 20/9, Part 2, p.5]

733. Adam questions whether the average jumper-over-extra charge applies in all areas or just CBD areas. Adam also queries whether the average charge is calculated based on CBD connections only, or connections in all areas. [Adam, 20/9, Part 2, p.7] Adam considers that (based on the information in Telstra's initial submission) the jumper over extra charge should be included within a CBD (Band 1) specific charge. [Adam 1/10, Part 3, p.7]

734. Telstra clarified that the jumper over extra charge is incurred in Bands 1 and 2, and not just CBD areas, and confirms that the average charge incurred is calculated by averaging over all LSS connections (and not just CBD connections). [Telstra, 2/10, Part 2, p.5]

– Materials

735. Telstra accepts that the cost of materials is included in the rates it has agreed with contractors. [Telstra, 20/9, Part 2, p.7] Telstra includes the cost of materials in calculating costs where Telstra staff makes the connection. [Telstra, 20/9, Part 2, Annexure B]

– Mark-up for indirect costs

736. Telstra submits that the proposed 10 per cent mark-up for indirect costs would be appropriate for the purpose of the final determination. [Telstra, 20/9, Part 2, p.7]

737. Adam submits that this allowance is too high, as Telstra is in the process of rationalising its contractual arrangements. Adam points to reported statements attributed to Telstra concerning anticipated cost savings to Telstra in managing contractors over the next two years. [Adam, 20/9, Part 2, p.8, Annexure 2(e)] In Adam's view, the mark-up should be reduced to 5 per cent. [Adam, 1/10, Part 2, p.5]

738. Telstra disputes that a 10 per cent allowance is excessive, on the basis that its actual contract management costs will remain significant following its announced rationalisation in contractor arrangements. Further, the scale of actual cost savings may not be as great as reported, and will not accrue this year. [Telstra, 2/10, Part 2, p.5]

739. Following the 2007 LSS pricing principles being issued, Telstra submitted that these pricing principles endorse the use of a 10 percent mark-up for indirect costs. [Telstra, 15/11, supplementary submission, p.2]

– Disconnections costs

740. Telstra supports LSS disconnection costs being based on the same allowances made for LSS connections (for common cost categories). [Telstra, 20/9, Part 2, p.7]

741. Adam objects to this approach, as the cost of removing jumpers would likely be less than the cost of connecting new jumpers, and Adam considers that paying an above cost charge would be contrary to the subsection 152CR(1) criteria. [Adam, 20/9, Part 2, p.11]

742. Telstra disputes that basing the disconnection charge on the connection charge will lead to this charge exceeding cost. [Telstra, 2/10, Part 2, p.9]

Commission's views

743. A number of the principles for setting LSS connection and disconnection charges are not controversial. It is generally not disputed, for instance, that the charge for connections and disconnections that are performed for Telstra by contractors should be set by reference to contractors' charges (together with a mark up for indirect and back-of-house costs).

744. Adam however raises a number of points for further consideration. First, Adam raises whether the agreed contractor charges may to some extent overstate the forward-looking efficient costs of connecting its LSS. However, the Commission considers that using the agreed rates is appropriate, as there does not appear to be significant potential for lesser rates to have been set on the basis of more efficient Telstra dispatch systems, or that the rates have otherwise been set at an unnecessarily high level. This approach is consistent with the 2007 LSS pricing principles.

745. The Commission notes that LSS and ADSL contractor charges agreed for 2007-08 do exceed those that Telstra previously anticipated applying in this period (and which were used in providing the draft final determination), but does not consider the rates to have diverged sufficiently from expectations such that they do not remain a reasonable benchmark for efficient costs. The Commission would of course reconsider this in future proceedings should it be established that contractor charges were increasing rapidly, or otherwise may not be reflective of efficient levels.

746. Adam also queries the amount and application of a jumper over extra charge component. This arose from the terms of Telstra's initial claim in its principal submissions. The Commission accepts Telstra's clarification that the charges it incurs are not limited to CBD areas and that the average allowance is calculated over all LSS connections. On this basis, the Commission has added a $1 allowance (**<c-i-c>**) to reflect the 'jumper-over extra charge'.

747. Adam seeks a reduction in the indirect cost mark up for contract management, on the basis of Telstra's reported rationalisation of these arrangements. The Commission acknowledges there is likely to be a reduction in Telstra's actual contract management costs to reduce as a result of this, although it also accepts Telstra's comments that the quantum and timing of any reduction is uncertain.

748. The proposed allowance of 10 percent was not set by reference to Telstra's actual costs, but what is considered a reasonable mark-up on contractor charges for efficiently incurred contract management costs. Although there is now some potential for a 10 percent allowance to be above efficient forward-looking levels, at this time the Commission does not consider that this is a significant risk. Accordingly, it has maintained the 10 percent allowance. This is consistent with the approach adopted in specifying the 2007 LSS pricing principles.

749. Adam also raises whether a reduction should be made to contractor charges for connections in setting the disconnection charge. Telstra disputes that using unadjusted connection costs in setting disconnection charges would lead to above cost pricing.

750. The Commission acknowledges that there is the potential for this approach to lead to a charge that will to some extent exceed the efficient forward-looking cost of making a disconnection. This is because less time would be required to disconnect a service rather than connect a service, and so contractors would likely levy a lesser charge. However, it is not clear that the difference would be large, or that Adam will often face a disconnection charge, and in these circumstances the Commission considers it should proceed on the basis that the contractor connection rates would still remain a suitable proxy for the allowance for efficient jumpering and associated costs in LSS disconnection charges. Accordingly, disconnection charges have been calculated on a similar basis to connection charges, except here an allowance for DAC group costs is not included.

751. Telstra seeks an increment to the connection charges to reflect a higher claimed cost when Telstra staff does the exchange-based work. This claimed increment results from 'blending' of discrete cost measures associated with (i) Telstra connected services; and (ii) contractor connected services.

752. The possible approaches open to the Commission are (i) to base the allowances for cost of exchange-based work that are included within LSS 'single' connection and disconnection charges on the cost of contractor-connected services, or (ii) to include an increment of the type that Telstra seeks.

753. This decision has the potential to have a significant effect on the LSS connection and disconnection charges, and so the Commission has assessed these two possible approaches against the subsection 152CR(1) criteria and the 2007 LSS pricing principles, as required under subsection 152AQA(6) of the Act. The Commission also had regard to the 2002 LSS pricing principles under subsection 152CR(2) of the Act.

Assessment against subsection 152CR(1) criteria

Paragraph 152CR(1)(a)

754. The first of these criteria concerns the promotion of the long-term interests of end-users (LTIE) of carriage services or of services supplied by means of carriage services. (paragraph 152CR(1)(a)) The Commission is directed to a number of subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-

(c), and subsection 152AB(7A)) The Commission has considered, in particular, the likely effect of each approach on:

- competition in markets for carriage services, and in particular broadband/DSL services;
- efficient use of and investment in infrastructure by which services are supplied (including the access network, and DSLAMs) or by which services are capable of being supplied (including a FTTN);
- the legitimate commercial interests of the supplier of the service, including its ability to exploit economies of scale and scope; and,
- incentives for investment in infrastructure, having regard to risks involved.

755. The Commission considers that allowing Telstra's increment would lessen competition should it result in the charges faced by access seekers exceeding the forward-looking efficient cost of connecting the LSS. In that case, access seekers would face charges based on costs that Telstra could avoid in the long run, resulting in access seekers facing a higher cost than Telstra for equivalent work. This would discourage efficient entry in downstream DSL markets.

756. A key consideration, then, is whether contractor charges are an appropriate benchmark for the efficient, forward-looking level of the cost categories that underlie those charges. This in turn calls for consideration of whether there are impediments in the long run to both:

- Telstra using contractors exclusively for exchange based work for the LSS and internal line sharing; and,
- Telstra being as efficient as that implied by the contractor charges when connecting services itself.

757. If so, then recognising an increment of the type Telstra seeks may be less likely to harm competition, provided that Telstra and access seekers would each face an equivalent cost base for connections going forward. However, unless both these conditions are met, then recognising the increment would impede competition.

758. While there are currently insufficient contractors to perform all LSS and downstream connections, it is reasonable to expect that over time Telstra would be able to use contractors to a greater extent. For instance, as competing service providers complete network migrations to LSS and/or ULLS platforms, existing contractor capacity will be able to be directed towards a greater number of 'single' connections.

759. On the second of these points, the Commission considers the level of cost Telstra incurs when connecting services will closely approach the levels implied by the contractor charges. Given that contractors are recovering their incremental costs (such as labour, travel and materials) and a contribution towards overheads and profit from their charges, it is not apparent why Telstra could not also achieve this level of costs when connecting the LSS and downstream services.

760. Telstra's claim around the costs it currently incurs when Telstra staff connect services is its actual, current cost, not its forward-looking efficient cost. The Commission does not consider that this claim represents a measure of Telstra's forward-looking efficient cost for these connections, and is certainly not the best available measure of the efficient, forward-looking cost of them.]

761. The Commission does not consider that the approach taken to this matter affects the objective of achieving any-to-any connectivity, or that the matters identified in paragraph 152AB(6)(a) are relevant here.

762. Turning to efficient investment in and use of infrastructure, the Commission firstly considers efficient use of and investment in infrastructure used to supply the LSS. The

Commission also considers consequences for efficient use, and investment in, the DSL access multiplexer (DSLAM) infrastructure used to supply downstream DSL services.

763. The Commission considers that efficient use and investment will be encouraged where Telstra is able to recover the efficient, forward-looking cost of making LSS connections, including a normal risk-adjusted return on capital employed. Connection charges above this level for LSS access seekers would, however, have the effect of discouraging efficient investment in and use of infrastructure used to supply the LSS. Use and investment in infrastructure to supply downstream services would also likely be below efficient levels as a result.

764. Also relevant here is the preceding discussion of whether, in the long run, there are impediments to Telstra meeting the efficiency benchmark implied by contractor charges across all LSS and 'downstream' connections. As discussed above, it is unclear whether such impediments currently exist, but if they do, the Commission considers that they will not persist. This does not mean that Telstra will be required to always use contractors to make LSS connections and disconnections. Where Telstra uses own staff for this work, the Commission considers that it will be able to realise efficiencies to the same extent as contractors have been able to achieve. Accordingly, the Commission considers that contractor charges provide an efficient benchmark for underlying cost categories for all LSS connections, and not just those performed by contractors. It follows that including an increment as sought by Telstra would discourage efficient use and investment.

765. Telstra's legitimate commercial interests include its ability to recover its costs and make a normal commercial return on capital employed. Setting LSS connection charges on contractor charges without the increment that Telstra has sought could be contrary to Telstra's legitimate interests should it prevent Telstra from recovering its costs. This will be more so where Telstra is not able to attain a cost base for all LSS and 'downstream' connections at the levels commensurate with those charges, or it takes longer to achieve that level of costs.

766. Telstra's legitimate commercial interests also include its ability to exploit economies of scale and scope. The Commission considers that not including the increment will increase Telstra's ability to exploit such economies. This is because by promoting competition, no including the increment will increase demand for LSS and downstream ADSL services. As there are fixed costs in producing LSS and ADSL, the increase in demand will give rise to economies of scale and scope. Telstra remain able to exploit the economies of scale and scope generated in the course of producing these services.

767. The Commission does not consider that this issue will have a strong bearing on incentives to invest in the infrastructure by which services are supplied. This is because in the long run on either approach Telstra will be able to recover its costs plus a normal risk-adjusted return on investment. And so, Telstra will have incentives to undertake efficient investments to allow it to supply LSS and ADSL services, having regard to the associated risks.

768. However, Telstra's incentives to invest in its LSS and ADSL connection processes could be strengthened by not including the claimed increment. This is because including the increment would tend to reduce incentives to invest in processes necessary to realise the cost levels that contractors have already achieved.

Paragraph 152CR(1)(b)

769. The next criterion concerns the legitimate business interests of the access provider, and the carrier's or provider's investment in facilities used to supply the declared service. (paragraph 152CR(1)(b)) The Commission's views on the effect of this decision on these matters are discussed as part of the first criterion. The Commission considers that in the short run, Telstra's legitimate business interests may not be met to the extent that excluding the increment would mean it could not recover the costs of connecting the

LSS and downstream ADSL. However, in the long run, the Commission considers that either approach will meet these considerations, as Telstra will be able to reduce its cost base to the levels already achieved by contractors.

Paragraph 152CR(1)(c)

770. The third criterion is the interests of all persons who have the right to use the service. (paragraph 152CR(1)(c)) The Commission considers that access seekers' interests lie in being able to compete for the custom of end-users on the basis of their relative merits.

771. It is in the interest of LSS access seekers to pay charges that reflect the efficient, forward-looking cost of connecting services. Paying connection charges on the basis of Telstra's actual cost base is contrary to this interest, as it would mean access seekers would pay higher charges in excess of forwarding-looking cost. If charges were based on Telstra's actual cost base, then Telstra will be less likely to seek out cost reductions that are open to it, with the result that LSS access seekers will continue to face excessive charges.

Paragraph 152CR(1)(d)

772. The fourth criterion is the direct cost of providing access to the declared service. (paragraph 152CR(1)(d)) It calls for consideration to be given to Telstra's ability to recover these costs.

773. The Commission considers that Telstra will likely recover the direct cost of providing LSS connections in the long run regardless of the approach taken to this issue. This will be the case provided that Telstra is able to reduce its cost base to the level implied by contractor charges, such as by increasing its use of contractors for LSS 'single' connections and disconnections or achieving cost savings when using own staff. Given that contractors have already achieved these efficiencies, any restriction on Telstra's ability to recover its actual costs incurred in connecting the LSS would not be expected to persist.

Paragraphs 152CR(1)(e) & (f)

774. The next two criteria are the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else; and the operational and technical requirements necessary for the safe and reliable operation of a carriage service, or a telecommunications network or a facility. (paragraphs 152CR(1)(e)-(f)) The cost of extensions to Telstra's ordering systems necessary to supply the LSS (or the ULLS) have been taken into account in other charges. The Commission does not consider that the 'operational and technical requirements' criterion materially contributes to this decision.

Paragraph 152CR(1)(g)

775. The last criterion is the economically efficient operation of a carriage service, a telecommunications network or a facility. (paragraph 152CR(1)(g))

776. As noted previously, the Commission considers that should an approach result in LSS connection charges that are above efficient forward-looking levels, this would impede competition in the provision of downstream (DSL) services. In these circumstances, Telstra would be able to set above-cost prices for its downstream services, leading to a reduction in the consumption of these services below efficient levels, and consequential allocative inefficiencies.

777. It follows from the above analysis that whether these charges should be based solely on costs incurred when contractors connect the service, or include an increment as sought by Telstra, calls for a weighing of competing criteria.

778. On the one hand, not including this increment may be contrary to Telstra's legitimate commercial and business interests to recover the costs it currently incurs in making these connections, including the recovery of direct costs of connecting services. Any

such impediment that may currently exist will, however, reduce as Telstra realises a more efficient cost base for making connections, to the levels that contractors have already achieved.

779. Turning to the remaining criteria, the long term interests of end-users (including the promotion of competition, efficiency in use and investment, and the ability to exploit economies of scale and scope), and the interests of persons with rights to use the declared service, will be promoted by not including the claimed increment in LSS connection charges.

780. Similarly, efficiency in use of carriage services and facilities used to provide them will also be encouraged by this approach, as it provides stronger incentives for Telstra to seek out and adopt the more efficient processes that have been employed to date by contractors. This could be by replicating the contractors' business model, or using contractors more.

781. Turning then to the LSS pricing principles, the Commission considers that neither the 2002 or 2007 LSS pricing principles would support the inclusion of the claimed increment.[38] The 2007 LSS pricing principles make this clear by specifying that LSS connection charges are to be set by reference to contractor charges. Each of the 2002 and 2007 pricing principles require TSLRIC+ prices, and hence only support the inclusion of costs that are representative of efficient, forward-looking levels. As already discussed, the Commission considers that contractor charges, and not Telstra's claimed costs when itself connecting services, represent efficient forward-looking cost levels.

782. Having regard to these matters, the Commission considers that LSS 'single' connection and disconnection charges should not include the increment as sought by Telstra. This is because those factors that could support the inclusion of the increment would not persist, while including the increment would discourage efficiency and impede competition over the long term. Further, the inclusion of the increment is contrary to the LSS pricing principles that are currently applying, and those that have applied previously.

783. In terms of the contractor charges to apply, the Commission has maintained its proposal to calculate separate costs for (i) connections currently being made by contractors, and (ii) other connections, as, although the same disaggregated cost data is applied, there is the potential for the geographic distribution of these connections to vary.

784. For the proportion of connections that were made by contractors (**<c-i-c>**), the Commission adopted the weighted-average contractor charges for LSS ('ADSL simplex') connections for 2006-07 that Telstra previously supplied.

785. The rates for 2007-08 have been increased slightly from those proposed in the draft final determination. This reflects that the 2007-08 contractor rates were set at a higher level than Telstra anticipated and which the Commission had used to calculate 2007-08 charges in the draft final determination. This is consistent with the 2007 LSS pricing principles and associated indicative rates.

786. For the remainder of connections (those currently performed by Telstra technicians), the Commission has again applied the contractor charge data that Telstra has supplied. The Telstra-reported contractor charge for 'tickets of work (TOW) 50-100 / day' is used as a proxy for the average contractor charge in metropolitan (Bands 1 and 2) areas. This is because in 2006-07 the average contractor charge aligned with this price

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[38] The Commission is required to have regard to the 2007 LSS pricing principles under section 152AQA(6) of the Act. The Commission may have regard to other matters, such as the 2002 LSS pricing principles, under subsection 152CR(2) of the Act.

point, and the Commission considers that the distribution of metropolitan connections around the contractual price points will not change materially in 2007-08. The Telstra-reported 'country' charge is used for connections in Band 3.

787. As actual distribution of these connections between bands is not known, the Commission has weighted the 'metro' and 'country' charge by the distribution of lines in Bands 1, 2 and 3 in order to calculate an average charge. Band 4 lines are not used, as the derived charges do not apply in band 4. This approach is consistent with the views of the parties. This approach results is the same weighting (**<c-i-c>**) that Telstra proposed.

788. The Commission acknowledges that there is some potential for this approach to over-weight the higher 'country' charge. As Band 3 exchange areas are larger, and LSS/ADSL services are only available within a limited distance from the exchange, a greater proportion of lines in band 3 (as compared to other bands) may not support LSS/ADSL services. And so, LSS/ADSL services would be expected to be more concentrated in metropolitan areas than the distribution of lines would suggest.

789. Telstra has stated that it reserves a right to connect LSS using only some contractors should the LSS connection charges be set at the levels that had been proposed. Adam notes it is indifferent to whether Telstra uses contractors or employees to do this, but disputes that there is grounds upon which Telstra should use only some contractors and not others. The Commission reminds Telstra that it owes standard access obligations to order and provision the LSS to an equivalent standard as it supplies to itself. The approach that has been adopted to setting LSS connection charges in this arbitration does not alter this obligation.

Conclusion on LSS 'single' connection and disconnection charges

790. This approach to back-of-house costs, and the jumpering and related cost categories, results in a LSS 'single' connection charge of:

- $38.70 for the period ending 30 June 2006,
- $39.30 for 2006-07,
- $41.40 for 2007-08, and
- $43.10 for July 2008 to 31 July 2009.

791. Resulting LSS 'single' disconnection charges are:

- $34.70 for the period ending 30 June 2006,
- $35.10 for 2006-07,
- $37.10 for 2007-08, and
- $38.70 for July 2008 to 31 July 2009.

792. The charges for the period ending 30 June 2006 and for 2006-07 are those that the Commission initially proposed to the parties in the DFD and August 2007 consultation paper. As noted previously, the 2007-08 charges have been revised up slightly from the DFD to reflect the 2007 LSS pricing principles (indicative prices). The charges for 2008-09 result from the delta analysis that is discussed in chapter 3 of these reasons.

Circumstances in which LSS 'single' disconnection charges are to apply

Introduction

793. Where a LSS disconnection request is made as a result of an end-user churning the downstream DSL service to another service provider, there is the potential for the removal of the existing jumpers being combined with installing the new jumpers on the relevant line. Where this work is combined, then overall costs can be significantly reduced, and costs of removing redundant jumpers recovered within the relevant connection charge.

794. The Commission has previously proposed that all disconnections as a result of churn should not be charged for, but Telstra raised concerns concerning its ability to implement this in practice. Under that approach, churns were to be identified by checking to see whether a new service was requested on the line within 30 days of the disconnection request.

795. More recently, in around December 2006, Telstra established a LSS/DSL churn process, and does not charge for disconnections that occur pursuant to it. This churn process has the potential to ensure that disconnection charges are only levied in those instances where an efficient access provider would need to separately disconnect a LSS. However, the success of this churn process to ensure that disconnection charges are not levied in respect of end-user churns will depend upon participation by significant service providers, including Telstra (Bigpond) and the access seeker (Adam).

796. Reflecting this, the Commission proposed to the parties to this arbitration in the August 2007 consultation paper that a disconnection charge should not be imposed in respect of disconnections where, either:

(i) the LSS disconnection is process under the Telstra LSS/DSL churn process, or

(ii) Adam is participating in the Telstra LSS churn process and Telstra (Bigpond) is not participating in the Telstra LSS churn process.

797. This is consistent with the approach that the Commission recently adopted in making FDs in other LSS arbitrations.[39] In the August 2007 discussion paper, the Commission drew these earlier decisions to the parties' attention. The Commission sought the parties' views on this approach.

Parties' submissions

798. Telstra agrees that a disconnection charge should not be imposed where the LSS is disconnected as a result of churn that occurs under the Telstra LSS churn process. Telstra does not charge for disconnections in this circumstance. Telstra advises that not all LSS disconnections will occur in this way, and for other LSS disconnections a charge should be paid.

799. Telstra submits that LSS jumpers should be disconnected soon after the service is cancelled, and when Telstra is unable to combine this task with a new connection on the line, Telstra will incur cost in disconnecting the jumpers. [Telstra, 20/9, Part 2, pp.7-8, Annexure C]

800. Telstra points to certain of the subsection 152CR(1) criteria as supporting the position that a charge should apply to all disconnections that occur outside the Telstra LSS churn process. Telstra submits that a charge should apply in order to ensure its direct costs are recovered and Telstra's legitimate business interests are met. Telstra also considers that a charge is necessary to ensure that its network operates in a safe and reliable manner, and to promote the LTIE. [Telstra, 20/9, Part 2, pp.8-9]

801. Telstra also submits that the Commission should not make disconnection charges conditional upon Telstra's decision as to whether its Bigpond retail business unit will participate in the LSS churn process. In Telstra's view, this condition would be contrary to the subsection 152CR(1) criteria and would operate as a punishment for Bigpond's failure to participate. [Telstra, 20/9, Part 2, p.8] Telstra describes imposing this condition as subverting the statutory criteria, and access seeker support for it unsurprising. [Telstra, 2/10, Part 2, p.8]

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[39] ACCC, *Publication of Final Determination and associated statement of reasons – Request/Telstra LSS access dispute*, August 2007

802. Telstra reiterates its view that this condition should not be imposed. Telstra states that specifying the proposed condition would impede Telstra from recovering its costs. [Telstra, 15/11, supplementary submission, p.2]

803. Adam supports the proposed approach to when LSS disconnection charges should be imposed. In particular, Adam considers that the condition around Adam and Bigpond's participation in the Telstra LSS churn process is important, as without this condition there is the potential for Adam to have to pay disconnection charges simply because of Bigpond's decision not to participate in the churn process. Adam considers that Bigpond would have relatively weak incentives to participate in a LSS churn process. [Adam, 20/9, Part 2, p.11]

804. Adam disputes that the proposed arrangements would prevent Telstra from recovering its costs. [Adam 1/10, Part 3, p.2] In its view, these arrangements are supported by a proper application of the subsection 152CR(1) criteria. Adam cites Consultel's views that it is inefficient not to align all exchange work that results from the end-user churning the service. [Adam 1/10, Part 3, pp.7-11]

805. Adam describes Telstra's refusal to participate in its own churn process as being for the purpose of dampening competition by increasing competitors' costs and making Bigpond customers less contestable by LSS-based service providers. [Adam, 1/10, Part 3, pp.10-12] Adam states that to date it has declined to participate in the LSS churn process, but that by promoting participation in the scheme the condition would bring industry-wide benefits. [Adam, 1/10, Part 3, p.14]

Commission's views

806. The parties agree that a LSS disconnection charge should not be imposed where the disconnection occurs under the Telstra LSS churn process.

807. Telstra has, after a long lead-time, introduced a churn process that includes the LSS. Telstra has noted the benefits of effective customer churn processes when introducing an earlier (2003) churn process for DSL services. Telstra's relevant retail business unit, Bigpond, and other significant service providers are not currently participating in the process however, although Bigpond does participate in the DSL churn process. [Telstra, DSL Transfer and DSL/SSS Transfer Process Participants, www.telstrawholesale.com accessed 14 December 2007] It appears that Telstra has decided that Bigpond will not participate in the LSS churn process for commercial reasons. [Whirlpool News, Cross DSLAM churn available soon, 15 December 2006.]

808. Telstra has previously provided details of the Telstra LSS churn process. This process allows services to be churned from one service provider to another upon the gaining service provider submitting an order. Participating service providers give a standing authority to transfer services they lose. The process is unavailable unless both the gaining service provider and losing service provider have agreed to participate. Where this process is used to transfer the service, Telstra does not apply a disconnection charge. [Telstra, 4/5, Part 3, pp.9-10] This churn process appears consistent with the DSL churn process, which has gained acceptance from a number of service providers.

809. The Telstra LSS churn process has potential to provide an effective means by which to churn a LSS (either to or from another LSS, or a DSL service), and would allow exchange work to be aligned, and unnecessary cost avoided.

810. The Commission remains concerned, though, as to whether the Telstra LSS churn process will be effective in ensuring that LSS access seekers do not pay for avoidable costs. That is, that access seekers do not pay for the disconnection of a churned service. As Bigpond (which has the largest share of DSL services) and other significant service providers are not participating, and the Telstra LSS churn process is available only where the gaining and losing service providers are participants, a significant number of end-user churns could still attract a disconnection charge.

811. It is not disputed that the value and effectiveness of the churn process will depend upon the extent of participation in it by significant service providers, such as Bigpond, and Telstra has itself expressed this view previously. Telstra reports that Bigpond supplies around 47 per cent of all retail broadband services. [Telstra, Full Year Newsletter, 2007, p.2] And so, Bigpond's participation in particular will have a significant influence on the effectiveness of the Telstra churn process.

812. Accordingly, the Commission has considered whether LSS disconnection charges should also be avoided in additional situations. In doing so, the Commission compares the following two options against the subsection 152CR(1) criteria: (1) allowing disconnection charges on all LSS disconnections that are not processed via the Telstra LSS churn process; and (2) disallowing LSS disconnection charges otherwise payable under option (1) where the LSS access seeker is a participant in the Telstra LSS churn process, but Telstra (Bigpond) is not.

813. The practical difference between these options is that Option (2) provides the parties incentives to participate in the Telstra LSS churn process, making the process more effective, and thereby more capable of ensuring that disconnections caused by end-user churn are not charged. In particular, Option (2) provides stronger incentives on Telstra (Bigpond) to participate. Bigpond currently has relatively weak incentives to participate. Unlike other service providers, Bigpond does not itself face these disconnection charges, and has a larger share of the retail market.

814. Further, as the parties are encouraged to participate in the Telstra LSS churn process, this will also encourage other significant service providers to participate. It can be noted that where Telstra has agreed to participate in the DSL only churn process, a total of 98 service providers have agreed to participate. Whereas, only 41 service providers have agreed to participate in the Telstra LSS churn process where Telstra does not participate. [Telstra, DSL Transfer and DSL/SSS Transfer Process Participants, www.telstrawholesale.com, accessed 14 December 2007]

815. In the short term, neither of these options will emulate the outcome of a condition that disallowed disconnection charges in all cases of end-user churn. For instance, Option (2) has the potential for additional disconnection charges to be disallowed (those relating to 'non-churns') until Bigpond participates in the Telstra LSS churn process. Whether this is the case will depend upon whether the access seeker has signed up to the process.

816. Conversely, each option has the potential to allow additional disconnection charges (where the disconnection is a churn processed outside the Telstra LSS churn process) until all significant service providers are participating. However, in the longer term, option (2) has the greater potential to ensure that disconnection charges are not imposed in cases of end-user churn.

817. Option 2 will be far simpler to implement as compared to possible alternatives of the type that the Commission proposed in previous arbitrations, which would require Telstra to assess each LSS disconnection to identify whether a new service has been installed on the relevant line within a certain period of time. In contrast, option 2 only requires Telstra to check at the time of the disconnection whether the access seeker and Bigpond have signed up to the Telstra LSS churn process. Listings of participants in the Telstra LSS churn process are readily available.

818. In applying the subsection 152CR(1) criteria, the Commission first considered the long-term interests of end-users. (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the objective of encouraging the economically efficient use of the economically efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

Assessment against subsection 152CR(1) criteria

Paragraph 152CR(1)(a)

819. Effective churn processes promote competition by removing obstacles to end-users gaining access to services provided by other service providers. End-users gain greater access to services offered by other service providers, as the time and expense associated with switching service provider is reduced, and there is less disruption to service provision.

820. While Telstra (Bigpond) does not participate, if Telstra gains the customer, then the losing LSS access seeker may be required to pay disconnection charges simply as a result of Telstra's decision not to participate. This will be the case where the losing service provider has provided a standing authority that would permit its services being cancelled and disconnected. Telstra's decision not to participate would also discourage others from participating, and so this could indirectly cause a losing service provider to pay for disconnection costs that could potentially have been avoided even if Telstra is not the acquiring service provider. Having to pay for avoidable costs will raise access seekers costs above efficient, forward-looking levels and reduce competition.

821. A gaining service provider that is participating in the Telstra DSL and LSS churn processes could use a two-stage process to churn a Telstra (Bigpond) end-user customer to a wholesale DSL service, and then to a LSS-based service, should Bigpond not participate in the Telstra LSS churn process. However, this will require more time and expense, which will inhibit access seekers in competing for these services. And so, option (2) will promote competition also by better permitting access seekers and Telstra to compete for existing services.

822. The Commission does not consider that the approach taken on this matter affects the objective of achieving any-to-any connectivity.

823. In terms of the matters specified at paragraph 152AB(6)(a), each approach will not compromise Telstra's practical ability to bill for the service. The specification of an approach that would require further level of detail as to the services being supplied on the line could be contrary to these considerations. This will be the case where Telstra's systems do not currently allow for their information to be automatically extracted or readily ascertained.

824. Economic efficiency in use of and investment in infrastructure used to provide listed services requires consideration of Telstra's infrastructure as well as the infrastructure of LSS access seekers. Obstacles to acquiring end-users customers, such as would exist in the absence of an effective churn process, would tend to discourage otherwise efficient use of and investment in infrastructure used to provide the LSS and downstream DSL services. This is because those restrictions would discourage take up of the LSS, and use of Telstra's LSS ordering systems, as well as discourage efficient investment in access seeker's DSLAMs. Option (2) would be preferable.

825. Telstra's legitimate commercial interests, including the recovery of costs and a normal risk-adjusted return, and the ability to exploit economies of scale and scope, are satisfied under all options. Telstra's interest in recovering necessary capital costs to augment ordering and associated systems, or operating expenses, is satisfied through the approach to setting cost-based LSS charges. Harmonising the approach with Telstra's current LSS churn process and systems further satisfies these interests.

826. Further, by encouraging efficiency in connecting churned services, contractors can complete a greater proportion of Telstra's exchange work, including connection of Telstra's retail services. This will reduce Telstra's cost base, as Telstra incurs lesser cost when contractors connect services than it currently incurs when own staff performs this work. Lowering connection costs makes it more likely that Telstra will be able to recover its costs.

827. To the extent that Option (2) could mean that Telstra would not recover disconnection costs it incurs until Bigpond participates in the Telstra LSS churn process, Telstra can avoid this outcome simply by deciding to participate in it own LSS churn process.

828. By promoting competition, demand for LSS and ADSL services will be encouraged. As stated previously, higher demand for these services will drive economies of scale and scope. Telstra remains able to exploit these economies as they are generated across its production processes.

829. The approach to this issue does not have a strong direct bearing on incentives for investment in infrastructure. However, by promoting competition, option (2) would indirectly increase incentives to invest efficiently in the supply of LSS and ADSL services.

Paragraph 152CR(1)(b)

830. The next criterion is the legitimate business interests of the provider and its investment in facilities used to provide the LSS (paragraph 152CR(1)(b)). This criterion is discussed as part of the first criterion. The Commission considers that either approach satisfies these interests. Under each, Telstra is not precluded from recovering its costs and a normal risk-adjusted return on investment in facilities to use the LSS.

Paragraph 152CR(1)(c)

831. Access seekers' interests lie in being able to compete on their relative merits without being impeded in acquiring end-user customers or incurring unnecessary cost. (paragraph 152CR(1)(c)) These interests are promoted by arrangements that provide better access to effective churn processes, and not incurring disconnection costs that could be avoided by such processes. As Telstra has recognised, the failure of significant service providers to participate in a churn process lessens its effectiveness and value to access seekers. It also makes it more likely that access seekers will face avoidable costs. The Commission considers that Option (2) would best meet these interests. Option (1) would be less likely to lead to an effective churn process, as little incentive is provided to Telstra (Bigpond) to participate, and this will also have consequences for other service providers in deciding whether to participate.

Paragraph 152CR(1)(d)

832. The next criterion is the direct costs of providing access to the LSS (paragraph 152CR(1)(d)). It is concerned with ensuring that Telstra will be able to recover its costs in providing access, in this context, the costs of disconnecting the LSS. As noted previously, on a forward-looking basis, Telstra remains able to recover its costs in disconnecting the LSS under either approach.

Paragraphs 152CR(1)(e) & (f)

833. The next two criteria are the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else; and the operational and technical requirements necessary for the safe and reliable operation of a carriage service, or a telecommunications network or a facility. (paragraphs 152CR(1)(e)-(f))

834. As noted above, system enhancements are unlikely to be needed as a result of harmonising these arrangements with the Telstra LSS churn process and other current systems. However, if either approach does necessitate system enhancements or extensions, these will be able to be recovered, including through LSS annual charges (subject to Telstra being able to demonstrate they were efficiently incurred).

835. Neither option prevents Telstra from disconnecting jumpers on cancelled LSS. Accordingly, the Commission does not accept Telstra's view that Option (2) would compromise the safe and reliable operation of the network. Telstra has objected to other approaches to LSS disconnection charges being adopted on the basis that its systems would not support their application. However, each option under consideration

in these proceedings is consistent with Telstra's current systems, and hence would be able to be implemented without potential for compromising operational quality or reliability of services.

Paragraph 152CR(1)(g)

836. The last criterion calls for consideration to be given to the economically efficient operation of a carriage service, network or facility, of either Telstra or other service providers. (paragraph 152CR(1)(g)) In this context, it calls for consideration to be given to the effectiveness of the LSS churn process that would be likely to result from each approach, and the resulting effect on competition. This is because dynamic efficiencies caused by competition in downstream services provide the best discipline on all service providers to operate in an economically efficient manner. It also calls for consideration to be given to productive and allocative efficiency.

837. Option (2) is preferred here as dynamic efficiencies are more strongly encouraged, as more downstream services will be likely to fall within the ambit of the Telstra LSS churn process. Also, access seekers will not face avoidable costs. This will reduce obstacles to a wide class of end-users gaining access to competing services, thereby promoting competition and dynamic efficiencies.

838. Productive efficiency gains (caused by processing churns as a single ticket of work) will be realised as further encouragement is given to service providers, including Telstra (Bigpond), to participate in the LSS churn process. Allocative efficiency will also increase as more service providers participate in the LSS churn process, and service providers pay only for costs that they cause (such as by the failure to participate in the Telstra LSS churn process).

Summary

839. And so, the Commission considers on balance that Option (2) will better serve the subsection 152CR(1) criteria. Although there is currently the potential for Telstra not to recover its direct costs of disconnecting some LSS that are cancelled, and for Telstra's legitimate business interests to be impaired as a result, whether this remains the case will depend upon Telstra's decision to participate in its own LSS churn process. By choosing to participate, Telstra will be able to recover its direct costs under option 2, and Telstra's legitimate business interests would not be compromised. Each of the remaining subsection 152CR(1) criteria supports the adoption of Option 2.

840. Further, option 2 is specified in the 2007 LSS pricing principles (indicative prices), and hence its adoption here is consistent with those pricing principles.

841. For these reasons, the Commission considers that Option (2) should be adopted. These arrangements will apply from the date that the FD comes into effect.

842. The Commission notes that it may be that some refinements in approach may be appropriate in future. For instance, further consideration may become necessary if a significant number of services remain outside the ambit of the LSS churn process, or any problems or limitations in the Telstra LSS churn process that could be identified in future are not able to be resolved.

Miscellaneous matters

843. The Commission raised with the parties a number of further issues that have a bearing on LSS 'single' connection and disconnection terms. Some of these have been discussed already. The Commission's views on these matters are as follows:

Discounts for unmanaged bulk connections

844. The Commission proposed that the charge for LSS 'single' connections should apply for bulk orders connected outside of a MNM.

845. Adam advises that discounts should be available for these LSS connections, as there is further potential for batching of work orders and resulting cost reductions. [Adam, 20/9, Part 2, p.12]

846. The Commission does not consider it appropriate to determine connection charges for unmanaged bulk connections, but rather considers that the charge for LSS 'single' connections should apply in those circumstances. This is because it considers that the average contractor charges already reflect a high degree of batching, and there appears little potential for further cost efficiencies arising because LSS orders are submitted at the one time.

Costs for 2006-07 and subsequent periods

847. The Commission proposed that costs for 2006-07 and 2007-08 should be measured by indexing 2005-06 costs where appropriate.

848. Telstra submits that the Commission should have regard for Telstra's costs that may have applied at the beginning of any period of backdating as well as more recent costs. For jumpering and associated costs, Telstra also submits that only the contractor rates applying in 2007-08 (which includes an increase over those applying in 2006-07) should be used to calculate these charges. Further, the actual agreed 2007-08 rates should be used in preference to those that were anticipated. [Telstra, 20/9, Part 2, pp.5-6]

849. Adam submits that ABS indices should be used. [Adam, 20/9, Part 2, p.11] Adam disputes that 2007-08 contractor charges should be used as an efficient benchmark for contractor charges in earlier financial years. [Adam 1/10, Part 3, pp.2, 6]

850. The Commission has separately estimated the efficient costs for each financial year by setting a benchmark for the efficient cost levels for each financial year. It has not adopted a single benchmark that applied in only one financial year as a benchmark for the efficient costs in another. The Commission considers that the difference in contractor rates that have been negotiated for the respective years reflect general escalation of these costs over time, and do not suggest that one or other may be above or below the efficient level of cost for that period.

851. For back-of-house costs, these were indexed by ABS 6345 Labour Price Index 'Ordinary time hourly rates of pay excluding bonuses; Australia; Communication services; Private; All occupations'.

852. For jumpering costs, the Commission has used actual rates agreed with contractors for financial years up to and including 2007-08. For 2008-09, the Commission has indexed the 2007-08 rates.

853. As materials costs are reflected in contractor charges, it is unnecessary to derive discrete cost allowances for this cost category. Annual changes in these costs are reflected in the escalation permitted under the contracts.

Cost model

854. A simple cost model that adopts the Commission's views is attached to these reasons. It is based on the same structure as the previous model. The contents of this cost model are to be treated as c-i-c and subject to the confidentiality undertakings given and directions made, as it reproduces information that is confidential to the parties.

855. A copy of the proposed cost model was provided to the parties for comment with the August 2007 discussion paper. Telstra suggests that there may be an error in the time allowance for the DAC in the cost model, as the allowance was set to zero. [Telstra, 20/9, Part 2, p.7]

856. Separate worksheets are provided in the cost model for LSS connections and disconnections. These correctly record the Commission's preferred allowances of 4

minutes for DAC involvement on average in LSS connections and 0 minutes for LSS disconnections.

857. Adam questions whether the precise cost estimates that are derived in the model should be rounded. If there is to be rounding, Adam considers that this should be to the nearest five cents only. [Adam, 20/9, Part 2, p.12]

858. Rounding of cost estimates is the usual approach in setting access charges, and recognises that there is a degree of imprecision and margin for error inherent in modelling of this nature. It represents a further conservative measure to ensure that charges are not set below efficient, forward-looking costs. The Commission considers that the proposed rounding is an appropriate allowance in this regard.

Averaged or de-averaged charges

859. As noted previously, the Commission decided to specify averaged LSS 'single' connection and disconnection charges.

Bands 1, 2, 3

860. The Commission did not specify charges to apply to LSS 'single' connections or disconnections in Band 4, as there is little if any demand for the LSS in this band. The parties agree that there is no need to specify these charges. [Telstra, 20/9, Part 2, p.9] [Adam, 20/9. Part 2, p.12]

Transfers from the ULLS to LSS

861. The Commission proposed not to specify charges to apply for the transfer of services from the ULLS to the LSS.

862. Telstra agreed with this approach. [Telstra, 20/9, Part 2, p.9] Adam had previously advised that it considered charges for this connection scenario should be specified. In its submission, Adam advised it had nothing further to add. [Adam, 20/9, Part 2, p.12]

863. The Commission remains of the view that there is little potential for these connections to be made within the period of the final determination even if it specified a price to apply to them. Accordingly, the Commission has not specified a charge to apply to this scenario in this arbitration.

4.2.8 Commencement date, expiry date and interest

864. The Commission has backdated the LSS 'single' connection and disconnection terms. These charges are to apply until 31 July 2009. Interest is payable on any over-payment that has occurred. The term of backdating, and reasons for this approach, are discussed previously.

4.2.9 Changes to draft final determination

865. The Commission provided a DFD to the parties for comment. Some of the terms specified in the FD differ to some extent to those proposed at the draft determination stage. These changes reflect revised cost data, backdating and expiry date. Reasons for these changes are discussed previously in these reasons.

866. Telstra suggests that the terms of the FD be further integrated into the existing commercial arrangements between the parties. In Telstra's view, this would better ensure that the parties are able to determine the arrangements to apply between them. Telstra did not suggest particular drafting changes. Telstra also submits that the charges should be expressed as being GST exclusive. [Telstra, 20/9, Part 2, pp.2, 4]

867. Adam disputes that the form of final determination should be altered to make its operation more certain. Adam agrees that the final determination should specify whether the charges are GST exclusive or inclusive. [Adam, 1/10, Part 3, p.2].

868. Telstra also suggests that the final determination specify that any backdated amount should be credited against current or future invoices rather than paid as lump sum, or that charges that are currently outstanding should be offset against the backdated amount. Otherwise, Telstra anticipates the backdated amount will provide windfall gains. [Telstra, 20/9, Part 2, p.2] Adam disputes this, stating that it is not in arrears, and this approach is not usual practice and would unnecessarily complicate interest calculations. [Adam, 1/10, Part 3, pp. 2, 15]

869. The Commission is willing to consider harmonising the terms of a determination with the contractual arrangements that exist between the parties. However, in this instance, particular drafting has not been suggested. Further, is not apparent that there would be the potential for confusion should the proposed approach be maintained.

870. The Commission has specified that the charges payable under the final determination are expressed on a GST exclusive basis. This is consistent with the commercial agreement between the parties, where prices are specified on a GST exclusive basis.

871. The backdated amount is to be paid and not credited against current or future invoices, unless the parties agree otherwise. This is the usual approach. The Commission accepts that there is the potential for delay in the effect of the final determination being realised by the access seeker, or for interest calculations to be unnecessarily complicated, were Telstra's suggested approach to be adopted.

872. The Commission does not consider that it should specify that outstanding charges owed by the access seeker should be offset against the backdated amount prior to payment. To do so would unnecessarily complicate the calculation and realisation of the backdating payment. Telstra remains able to separately obtain payment on any outstanding accounts owed by Adam, and there is no suggestion that Adam would be unable to pay these accounts as they fall due.

4.3 LSS Managed Network Migration ('MNM') terms and conditions

4.3.1 Background

873. A Managed Network Migration is a transfer or migration of services that is achieved by the project management by Telstra of a coordinated cancellation and connection of services.

874. MNM terms include charges payable for connections, disconnections, or order cancellations, and preconditions to ordering a MNM.

875. Adam and Telstra are in dispute over the MNM terms to apply to the LSS.

876. There is potentially a number of different types of network migrations that could be requested. In these proceedings, consideration was given to migration from a wholesale DSL platform to the LSS; and migration from a LSS platform to a ULLS platform.

4.3.2 Current terms and conditions

877. The LSS MNM terms and conditions currently applying between the parties are those set out in Customer Relationship Agreement (CRA) 192.

4.3.3 Prior consideration

878. LSS MNM terms and conditions have been considered by the Commission in other arbitrations, and the Commission has published extracts from the reasons for decision issued in those arbitrations: ACCC, *Statement of reasons relating to an interim determination*, 12 July 2006 (Primus dispute); *Reasons for interim determination*, 2 November 2006 (Request dispute); *Reasons for interim determination*, 2 November 2006, and *Reasons for interim determination*, 21 December 2006, (Chime dispute)

ACCC, *Publication of Final Determination and statement of reasons – Request/Telstra LSS access dispute*, August 2007. (www.accc.gov.au)

4.3.4 Principles to apply

879. The Commission proposed to the parties that the price-related terms for LSS MNMs should be determined having regard to the LSS pricing principles. Initially the parties' views were sought on the 2002 LSS pricing principles. Supplementary submissions were later sought on the use of the 2007 LSS pricing principles to set these charges. The parties' submissions regarding the use of these principles are discussed previously.

880. The parties' views on the 2002 and 2007 LSS pricing principles are discussed previously in these reasons. Relevantly, Adam considers charges should be de-averaged, as its business is conducted predominately in Band 2 and averaging has the potential to increase charges as higher cost areas are included in the averaging process. [Adam, 20/9, Part 2, pp.13, 16]

881. Telstra points to prior ACCC decisions in which averaged charges have been used on the basis that costs do not differ materially between geographic areas. Telstra submits that this approach is also applicable here, as any difference in cost is immaterial. [Telstra, 2/10, Part 2, p.2].

882. Telstra disputes Adam's claim that average charges would be inappropriate. Telstra submits that averaged charges are appropriate, as it considers this approach would promote investment in regional areas, and for other reasons. [Telstra, 20/9, Part 3, p.2, 5; Telstra, 2/10, p.2]

883. Also, Telstra objects to the 2007 LSS pricing principles requirement that minimum exchange charges should be based on a MNM involving the connection of 20 services. [Telstra 15/11, supplementary submission, pp.2-3]

884. The Commission has had regard to the 2007 LSS pricing principles as required by sub-section 152AQA(6) of the Act in determining the price-related terms for LSS MNMs. Under those principles, these charges should comprise the forward-looking efficient costs of connecting and disconnecting the LSS as part of a MNM. Further, in principle, these charges should be geographically de-averaged. However, averaged prices can be justified where the distortionary effect of an averaged charge is not significant. Here, the same costs (categories and level) apply to LSS MNMs across the different geographic bands. Hence, averaging across the geographic bands does not lead to a different charge.

885. As discussed further below, the Commission considers that basing the minimum exchange charge on a MNM of 20 services is appropriate, and so has applied the 2007 LSS pricing principles requirement in this regard.

4.3.5 Technical advice

Introduction

886. The Commission has received a number of reports (some of a draft or interim nature) concerning the connection or disconnection of the LSS. The reports that are relevant to an assessment of the efficient costs of LSS MNM costs are:

   - Consultel, *Analysis relating to Primus / Telstra LSS Dispute interim report*, February 2006
   - Consultel, *Small Scale MNMs between wholesale ADSL, ULLS and LSS – Interim report*, March 2007

887. The Commission proposed to the parties that these reports should be considered, and further that Dr Brooks' views should be sought on relevant points raised in the parties' submissions. The Commission sought the parties' views on this approach.

Parties' submissions

888. Telstra submits that the Commission should not have regard to the Consultel reports. Telstra's criticisms regarding reliance on Consultel's reports are discussed previously. In the alternative, Telstra considers that before the reports are relied upon, they should be finalised and then distributed to the parties in this form for comment. [Telstra, 20/9, Part 3, p.2]

889. Adam does not object to the Commission having regard to the Consultel reports. [Adam, 20/9, Part 2, p.13] At various occasions, Adam cites the Consultel reports in support of its contentions.

Commission's views

890. Dr Brooks and Consultel are qualified to provide advice to the Commission regarding the systems and processes that are used to make LSS MNMs. The Commission considers that Dr Brooks and Consultel are impartial, and does not consider that they could reasonably be perceived to be otherwise.

891. Further, the Commission considered that it was appropriate to proceed on the basis of the Consultel reports, including those described as of a draft or interim nature. The parties had the opportunity to comment on these reports. Accordingly, the Commission has had regard to the Consultel reports in reaching its decision.

4.3.6 Assessment of efficient costs

Introduction

892. There are a number of distinct cost categories that are relevant to LSS connections and disconnections.

- 'Back-of-house' costs
- Jumpering, travel, vehicle, tool and materials (copper pairs) costs
- Indirect costs

893. Telstra uses third party contractors to perform the exchange-based work necessary to connect and disconnect the LSS as part of a MNM. Telstra staff and systems perform back-of-house tasks.

'Back of house' costs

Introduction

894. Costs associated with the following Telstra workgroups and processes are considered within this category:

- Wholesale customer service group (WCSG)
- Wholesale Product Delivery (WPD), which includes the data activation centre (DAC)
- Integrated deployment solution centre (IDS)

895. These work groups have periodically been reorganised. Now, some of these functions are performed by the Wholesale Broadband Infrastructure and Operations (WBI&O) group and the Product Delivery Co-ordination (PDC) team.

896. The Commission proposed to include an allowance for IDS group costs within LSS MNM connection charges, and to base this allowance on advice previously provided by Consultel concerning the efficient cost associated with IDS group tasks. The relevant costs are those incurred by Telstra in coordinating LSS MNMs and scheduling contractors to perform them. However, the costs associated with Telstra's wholesale customer front of house activities (WCSG and WPD) are recovered through LSS annual charges.

Parties' submissions

897. Telstra considers that the proposed $60 hourly labour rate for IDS group staff is quite low, although it was not in a position to provide an estimate of what it considers the efficient forward-looking labour cost for the IDS group would be. In Telstra's view, this would vary from team to team within the IDS group, depending upon tasks performed.

898. Telstra states that it would not object to the proposed allowance for IDS group costs, provided that an allowance was made for costs associated with the WCSG and WPD work groups. Telstra submits that if this is done, then the total allowance for these work groups would align with efficient cost measures for all 'back-and-front-of-house' functions that are derived from Telstra's accounts. Telstra provides details of how these costs have changed over time as manual tasks have been automated. [Telstra, 20/9, Part 3, pp.3-5, Annexures A, B, C]

899. Telstra reiterates its view that wholesale front of house costs should be included in the cost base that is recovered via LSS connection and disconnection charges. [Telstra, 15/11, supplementary submission, pp.2-3]

900. Adam submits that the proposed $60 hourly rate for IDS group staff is too high, based upon survey data concerning salary levels across the Australian telecommunications industry. Adam states that this rate is considerably higher than the uplifted salary reported for customer service representatives in that survey. [Adam, 20/9, Part 2, p.15, Annexure 2(e)] Adam also queries whether the costs associated with IDS employees liaising with contractors may already be recovered within the indirect cost allowance. [Adam, 1/10, Part 4, p.4]

901. Telstra disputes that the surveyed customer service salary rates are appropriate, as the skill sets do not align with those required of Telstra's IDS workgroups. Telstra states the surveyed customer service position is a front of house role, whereas its IDS workgroup requires technical skills. Telstra also states that the survey rates of pay appear to understate salary uplifts for overheads. [Telstra, 2/10, Part 2, pp. 6-8]

902. Telstra submits that WCSG and WPD group costs should be recovered in LSS MNM charges, and to this end has excluded costs associated with these groups from the cost claim it has made in these proceedings in respect of LSS annual charges. In the alternative, Telstra submits that its cost claim for annual charges should be increased to include costs associated with these work groups.

903. Adam submits that WCSG and WPD group costs should not be included in calculating MNM connection charges as they are recovered through LSS annual charges. [Adam, 20/9, Part 2, p.15] In the alternative, it submits that any allowance should not reflect inefficient manual processing that occurred. [Adam, 1/10, Part 4, p. 3]

Commission's views

904. The Commission has considered the parties' submissions, but determined to maintain its estimates of efficient back-of-house costs that were proposed to the parties, and to include an allowance for efficiently incurred IDS group costs. The measure of efficient IDS related costs are derived by multiplying (i) an hourly labour cost, by (ii) the amount of time it would take an efficient operator to perform IDS functions in relation to a LSS MNM (as claimed by Telstra).

905. The efficient hourly labour cost that the Commission considers appropriate for the period up to 30 June 2006 is $60, with an annual indexing used for later years. This is considered to result in a reasonable measure of the respective costs that Telstra incurs for each period on an efficient and forward-looking basis, and falls between the rates advocated by the parties in these proceedings.

906. The Commission does not consider that the costs associated with the tasks performed by the IDS group would already be recovered within the indirect cost mark-up. The

mark-up for indirect costs is to cover the costs of managing contracts and billing, and not the day-to-day activities of the IDS group in scheduling work.

907. Adopting the position advocated by Adam would have reduced the allowance for back-of-house costs below these levels. The Commission has assessed its proposed approach and that advocated by Adam against the subsection 152CR(1) criteria.

908. In terms of the promotion of competition, Adam's position would be preferable if this better reflects the forward-looking, efficient cost of performing the IDS group tasks.

909. However, the Commission is not satisfied that using the surveyed salary costs proposed by Adam would be a suitable benchmark for efficient forward-looking costs of the IDS group, given the potential for the work performed by each workforce to differ.

910. For similar reasons, the Commission considers that adopting Adam's position would not better encourage more efficient use of and investment in infrastructure, or the efficient supply of the LSS and downstream services, or is necessary to satisfy access seeker's interests in competing on their merits. On the other hand, adopting this approach would tend to compromise Telstra's legitimate interests, including its ability to recover direct costs, to the extent that Telstra could not attain salary and on costs for IDS staff, at the levels advocated by Adam.

911. The Commission has not included in LSS MNM connection charges an allowance for WCSG and WPD costs. The costs of these work groups are reflected in the cost pool that the Commission has recognised for the purposes of setting LSS annual charges.

912. This approach results in an allowance for back-of-house costs of $126 per MNM for the period ending 30 June 2006, indexed for later years.

Jumpering, travel, vehicle and tool costs; Materials costs; Mark-up for indirect costs

913. The Commission proposed to base the efficient costs for jumpering, travel, vehicle and tool cost categories for MNMs on third party contractor rates that Telstra supplied.

914. Telstra provided details of the contractor charges that applied until 1 June 2006, (*Telstra, Primus LSS access dispute – Telstra's submission*, August 2005, Annexure A) and the contractor charges that have applied since that time. (Telstra, 10 July 2007)

915. These rates are for LSS MNM connections made, by way of pre-jumpering and cut-over, either in the one visit or in two visits to the exchange. The Commission proposed to calculate the efficient cost estimate on the scenario where MNMs were performed in two stages: a pre-jumpering stage, and a cutover stage.

916. The Commission proposed not to make a separate allowance for the materials cost (i.e., the cost of copper pairs used to connect points on the MDF), as the contractor charge includes this cost.

917. The Commission proposed a mark-up of 10 percent on third party contractor rates to cover indirect costs such as contract management costs, in preference to Telstra's previously claimed mark-up of **<c-i-c>** percent. This reflected the view that when using third party contractors, Telstra will avoid the indirect cost categories that comprise its claimed mark-up. Further, efficiently incurred contract management costs would not represent a significant component of per LSS connection costs.

918. The Commission sought the parties' views.

Parties' submissions

919. Telstra confirms the contractor charges for MNMs for each period. [Telstra 20/9, Part 3, p.3]

920. Telstra considers that efficient costs should be modelled upon the scenario where two visits are required. [Telstra, 20/9, Part 3, p.3] Telstra states that this approach was developed in consultation with access seekers and is more efficient as it maximises cutovers per day. Further, Telstra anticipates that adopting a combined single visit

MNM process would lead to higher back of house costs, and increase provisioning times. [Telstra, 2/10, Part 3, p.1]

921. Adam submits that the efficient benchmark should be the contractors charge where a single stage process is adopted, as in its view this is the more efficient, lesser-cost process. Adam states that it does not require Telstra to adopt the higher cost process. [Adam, 20/9, Part 2, pp.13-14] Adam points to the likelihood of unnecessary pre-jumpering work on services that are cancelled close to the scheduled cutover date to say that two stage processes are inefficient. [Adam, 1/10, Part 4, p.3]

922. Telstra objects to the MNM connection charge being based upon the lower price point for a two visit MNM scenario. This is because, as the price points are for different geographic areas, Telstra will incur higher costs for some MNMs than the proposed allowance. Telstra considers the Commission should adopt the average of the price points for this scenario. [Telstra, 20/9, Part 3, p.3] Telstra considers this is necessary to ensure direct costs are recovered, and other of the subsection 152CR(1) criteria are satisfied. [Telstra, 20/9, Part 3, pp.7-8]

923. Adam disputes that charges should be set at the simple average of rates agreed with different contractors. Adam submits that there is the potential for Telstra's actual costs to differ from what might be suggested by a simple average of these charges, as the actual average would depend upon the distribution of work between contractors. [Adam, 1/10, Part 4, p.2]

924. Adam questions the appropriateness of a 10 per cent allowance for indirect costs given the recently announced rationalisation of Telstra's contractor arrangements. Adam submits that these initiatives will lead to cost savings to Telstra. [Adam, 20/9, Part 2, p.15] Adam suggests the allowance should be set at 5 per cent. [Adam, 1/10, Part 3, p.7]

925. Telstra does not object to a 10 per cent mark-up for indirect costs. [Telstra 20/9, Part 3, p.3] Telstra disputes that a 10 per cent allowance is excessive, on the basis that its actual contract management costs will remain significant following its announced rationalisation in contractor arrangements. Further, reports of the scale of actual cost savings may not be as great as reported, and will not accrue this year. [Telstra, 2/10, Part 2, p.5]

926. Telstra confirms that the contractor charges include the cost of materials. [Telstra 20/9, Part 3, p.3]

Commission's views

927. As contractors incur the cost of materials, they are already reflected in contractors' charges and the Commission has not included a further and discrete allowance for materials costs.

928. The Commission has maintained the proposed 10% mark-up for indirect costs. As previously discussed, the Commission accepts that Telstra's contract management costs will likely reduce. However, the 10 per cent allowance was not estimated by reference to Telstra's current actual costs, but rather a view as to the likely level of mark-up reasonably required by an efficient operator. The Commission remains of the view that this level of mark-up remains reflective of this requirement, which is consistent with the 2007 LSS pricing principles.

929. The remaining issue concerns how the allowance should be calculated for jumpering and associated cost categories. In this regard, the Commission has maintained its proposed approach and used the agreed MNM rates as an efficient benchmark for the jumpering and associated costs for MNMs.

930. In doing so, the Commission notes that contractor rates for LSS 'single' connections are pegged to rates for 'ADSL simplex' connections; but LSS MNMs are performed for access seekers alone. Telstra may not have as compelling an incentive to seek the

most efficient connection costs for LSS MNMs, given these flow through to LSS access seekers only.

931. As contractors have agreed to perform LSS 'single' (and ADSL simplex) connections on average more cheaply than the agreed rate for LSS MNM connections, there could be scope to reduce the allowance for jumpering costs for MNM connections. At this time, the Commission has not done so. However, further consideration could be given to this option should LSS MNM connection rates remain above LSS 'single' connection rates.

932. A key area of contention between the parties was the method by which the MNM connection charge should be derived from the various contractor charges that Telstra has negotiated. Different contractor charges apply depending upon whether the MNM involves a combined single visit or occurs in two stages over two visits.

933. Here, the approaches that the Commission could adopt would be:

(i) to model jumpering and related costs on only a single visit / stage process;

(ii) to model efficient jumpering and related costs on a two visit / stage process; or

(iii) to have regard to the charges that apply in each scenario. The Commission has assessed these options against the subsection 152CR(1) criteria.

Assessment against subsection 152CR(1) criteria

Paragraph 152CR(1)(a)

934. The first criterion is the promotion of the long-term interests of end-users (paragraph 152CR(1)(a)). This calls for consideration of a number of factors identified in section 152AB, being the objective of promoting competition, the objective of achieving any-to-any connectivity, the objective of encouraging the economically efficient use of the economically efficient investment in infrastructure, and subsidiary matters. (paragraphs 152AB(2)(c)-(e), subsection 152AB(4), paragraphs 152AB(6)(a)-(c), and subsection 152AB(7A)).

935. On the promotion of competition, a single process would be preferable if this better reflects the forward-looking, efficient cost of performing MNM connections. If so, this would better facilitate efficient entry by service providers in the supply of downstream DSL services. The effect on competition would be most pronounced in marginal exchange areas, where higher MNM charges may preclude entry by LSS-based suppliers, with consequential effects for the quality and variety of services offered, and the price at which services are available, in those areas.

936. The Commission accepts that Adam (together with other LSS access seekers) does not require a two-stage process to be followed. This does not however establish whether, looking forward, one or other approach would be more efficient in a particular instance. The fact that Telstra has negotiated rates for each eventuality and that Adam does not require a two vistit / stage process suggests that a single stage process could be more efficient for some MNMs at least.

937. However the Commission anticipates that the least cost approach could vary between MNMs, depending upon whether, e.g., pre-jumpering would increase or decrease the number of technician days required for that MNM. It will also be influenced, at least in the longer term, by whether contractors would be able and willing to perform all MNMs in a 'single stage / visit' process.

938. The Commission does not consider that the any-to-any connectivity objective influences this decision, or that the matters identified in paragraph 152AB(6)(a) have a material bearing on this question.

939. Next, efficient use and investment will be encouraged where Telstra is able to recover efficiently-incurred costs of MNMs, including a normal commercial return on capital

employed. MNM charges above this level for LSS-based competitors would have the effect of discouraging efficient investment in and use of infrastructure used to supply the LSS. Use and investment in downstream services would likely be below efficient levels as a result.

940. The parties have respectively identified possible causes of inefficiency present in using either a single stage or two stage approach. On the one hand, two stage processes will require unnecessary work on lines withdrawn from a MNM close to cutover date, and will tend towards additional travel costs; while a single stage process will extend the cutover processes with the potential for more down time on end-user services. In these circumstances, there is no obvious choice as to which process will always be the more efficient process to adopt.

941. Following on from the discussion regarding the promotion of competition, the Commission considers that the efficient, forward-looking level of these cost categories would likely fall somewhere in between the contractor charges that apply to the single stage and two-stage process. This is on the basis that some MNMs will use a single process, and others follow a two-stage process. The actual cost will depend upon the distribution of MNM connections amongst the price points. On the basis that these are evenly distributed, then the actual cost to Telstra will equal the simple average of the price points. The Commission has decided to take a conservative approach however and provide an allowance that exceeds the simple average, to account for the possibility that the distribution of MNM connections will be skewed towards the more expensive price points.

942. Telstra's legitimate commercial interests, including its interest in recovering its direct costs would be satisfied by proceeding on the basis that a mix of single and two stage MNMs are performed. Assuming a two-stage process is always required would lead to charges above those necessary to meet these interests, while assuming only single stage MNMs will occur would prevent full cost recovery except for those MNMs where a single stage process is in fact adopted.

943. For MNMs performed to date, Telstra consulted at least some access seekers and it was their preference for a two-stage process to be adopted. This approach appears to represent a higher quality service, in that it has the potential to minimise necessary disruptions to end-user service provision.

944. Looking ahead, the Commission considers that the efficient level of costs will reflect the scenario where a mix of two-stage and single-stage MNMs are conducted. Setting MNM charges on this basis would be preferable having regard to encouraging efficient investment incentives, and promoting competition, encouraging dynamic efficiencies and promoting demand for downstream services. Growing demand will in turn generate economies of scale and scope across production processes which Telstra is able to exploit. Telstra will be able to recover its costs, as it will be able to arrange for MNMs to be conducted either in a single-stage process, rather than offering a two-stage process only.

Paragraph 152CR(1)(b)

945. The next criterion concerns the legitimate business interests of the access provider, and the carrier's or provider's investment in facilities used to supply the declared service. (paragraph 152CR(1)(b)) The Commission's views on the effect of this decision on these matters are discussed as part of the first criterion. It would be contrary to Telstra's legitimate interests to now model costs on only the lesser-quality single-stage approach. These would be better met by basing MNM charges on a two-stage process, especially for MNMs previously performed.

Paragraph 152CR(1)(c)

946. The next criterion is the interests of all persons with rights to use the LSS (paragraph 152CR(1)(c)). Access seekers' interests lie in being able to compete on their relative

merits. Access seekers' interests could tend to be compromised by basing MNM charges on only the charges associated with a two-stage process should they not require the increased quality associated with the two-stage process. This could impede their ability to compete on their merits to the extent that it allowed costs to exceed the actual charges paid to contractors, or the increased costs could not be justified in terms of the associated increase in quality.

Paragraph 152CR(1)(d)

947. The next criterion concerns the direct costs of providing access to the LSS (paragraph 152CR(1)(d)). Telstra's ability to recover the direct costs of MNMs (including a contribution to overheads) will be promoted by basing MNM charges on a two-stage process. However, this approach may exceed what is required to recover direct costs going forward, given that at least some MNMs can be conducted in a single-stage process.

Paragraphs 152CR(1)(e) & (f)

948. The Commission does not consider that the next two criteria are relevant to this decision (paragraph 152CR(1)(e)-(f)). There is no information to suggest that adopting one or other approach would lead to unsafe practices being used.

Paragraph 152CR(1)(g)

949. The last criterion concerns the economically efficient operation of a carriage service, a telecommunications network or a facility. (paragraph 152CR(1)(g)) As noted above, the Commission considers that should an approach result in MNM charges that are above efficient forward-looking levels, then this would impede competition. If so, Telstra would be able to set above-cost prices for its services, leading to a reduction in the consumption of these services below efficient levels, and consequential allocative inefficiencies.

950. Resolving conflicting criteria is a matter of judgment. At this time, the Commission considers that it would be more consistent with the statutory criteria to base MNM connection charges on the scenario where MNMs are conducted using a mix of two visit / stage MNMs and single visit / stage MNMs, rather than only one or the other. However, the case for using only two visit MNM charges is stronger for MNMs that have already occurred.

951. Accordingly, the Commission has set the allowance for jumpering and associated costs for the period up to June 2007 on the contractor charge that applied to a two-stage process. For MNMs since that time, the Commission has set this allowance based upon the lesser contractor charge for a two-stage MNM process.

952. The allowance was not calculated by averaging the two price points, as Telstra suggested may be necessary to ensure its direct costs are recovered and other of the subsection 152CR(1) criteria satisfied. This proposal would have increased this allowance by around $0.55 for MNM connections occurring in June 2007 and following.

953. The Commission accepts that for some MNMs, being those that involve a two visit / stage process in those States or regions in which the higher cost contractor operates, the contractor charge will be higher than the allowance. However, for other MNMs, being those that are completed in a single visit / stage, the charge will be less than the allowance. The actual average charge faced by Telstra will depend upon the distribution of MNMs around all of the contracted price points, but a simple averaging of the price points ($26.40) does not suggest that the average charge Telstra faces will be higher than the proposed allowance ($28.05), even if these are currently skewed towards higher cost MNM two-stage processes.

954. Telstra advised that it may need to revise its back of house systems and processes before single visit MNMs can be offered. However, the Commission notes that Telstra

has negotiated a single visit MNM charge with contractors, and considers that Telstra would not have done so if significant changes in its processes were necessary before single stage MNMs could be undertaken.

955. Lastly, it is possible that Adam may prefer that a single-stage process (or a two stage process) be adopted exclusively for its future MNMs. If so, the parties can negotiate MNM connection charges on that basis.

Costs for 2006-07 and subsequent periods

956. The Commission indexed the back-of-house costs for 2006-07 and subsequent periods. The Commission used *ABS 6345 Labour Price Index 'Ordinary time hourly rates of pay excluding bonuses; Australia; Communication services; Private; All occupations'*. The parties did not object to this approach. [Adam, 20/9, Part 2, p.15] [Telstra, 20/9, Part 3, p.5]

957. In setting the allowance for contractor charges, the Commission has used the rates as negotiated for each period up to 2007-08. The Commission has indexed these contractor charges for 2008-09 using the above labour price index. This approach results in charges that are consistent with the 2007 LSS pricing principles and the indicative prices.

Cost model

958. A simple cost model that adopts the Commission's views is attached to these reasons. This model is further simplified from the model distributed at the draft determination stage. The contents of this cost model are to be treated as [c-i-c] and subject to the confidentiality undertakings given and directions made, as it reproduces information that is confidential to the parties.

959. Telstra did not object to the use of this model. Its comments were directed to particular input values used. These comments are discussed elsewhere. [Telstra, 20/9, Part 3, p.5]

960. Adam questions whether the results of the cost model should be rounded, or if so, whether it rounding should be limited to the nearest 5 cents, rather the ten cents proposed. [Adam, 20/9, Part 2, p.15]

961. Rounding of cost estimates is the usual approach in setting access charges, and recognises that there is a degree of imprecision and margin for error inherent in modelling of this nature. It represents a further conservative measure to ensure that charges are not set below efficient, forward-looking costs. The Commission considers that the proposed rounding is an appropriate allowance in this regard.

Averaged or de-averaged charges

962. As noted previously, the Commission decided to base MNM charges on a geographically averaged estimate of the efficient costs of providing these MNMs. This is because the costs of MNMs do not differ significantly between geographic bands.

Bands 1, 2, 3

963. The Commission did not specify charges to apply to LSS MNMs in Band 4, as there is little if any demand for these connections. The parties agree with this approach. [Adam, 20/9, Part 2, p.16]

964. Telstra also states that its costs of completing LSS MNMs in Band 4 should still be taken into account. [Telstra, Part 3, p.6] It is not necessary to consider this, as the Commission does not consider that any such MNMs are likely, and hence no such costs would be incurred.

4.3.7 MNM connection charge

965. The Commission proposed a two-part tariff to apply to connection charges whereby back-of-house costs are recovered in a fixed component and other costs recovered in a variable per service component. The parties' did not object to this approach.

966. The following charges result from this approach, and from the Commission's approach to back-of-house costs, indirect costs and the jumpering and related cost categories:

(a) for 2004-05 and 2005-06

Component	Charge
– Fixed amount	$126.00 (per MNM)
– Variable amount	+ $28.70 (per connection)

(b) for the period from 1 July 2006 to 31 May 2007

Component	Charge
– Fixed amount	$130.20 (per MNM)
– Variable amount	+ $28.70 (per connection)

(c) for the period from 1 June 2007 to 30 June 2008

Component	Charge
– Fixed amount	$134.50 (per MNM)
– Variable amount	+ $30.90 (per connection)

(d) for the period from 1 July 2008 to 31 July 2009

Component	Charge
– Fixed amount	$140.10 (per MNM)
– Variable amount	+ $32.20 (per connection)

MNM disconnection charges

967. The Commission proposed not to allow LSS disconnection charges where the LSS is disconnected as part of a MNM. This reflected the view that any associated costs would be taken into account in setting connection charges for that MNM type. The migration type to which this is potentially of more relevance is a migration from the LSS to ULLS. The parties did not object to this approach being adopted. [Telstra, 4/5, Part 3, p.6] [Adam, Part 2, p.15]

4.3.8 Cancellation charges

Introduction

968. The Commission proposed that cancellation charges are to be paid where an entire MNM is cancelled to ensure that back of house planning costs are recovered. The Commission also proposed that where the number of services to be connected as part of

a MNM is reduced, 20 business days or less from the cutover date, Telstra should be able to impose a further charge to reflect costs incurred in pre-jumpering.

969. The proposed charges were around $126 for an entire MNM cancellation, and a charge of $23.60 per cancelled service where the cancellation follows pre-jumpering.

Parties' submissions

970. Telstra submits that early project management costs are significant and should be able to be recovered when the MNM is cancelled. Telstra considers this cancellation charge should approximate the costs incurred by its back of house work units per cancelled service. Further, Telstra considers this charge should be payable where a MNM proceeds but with fewer services. Telstra considers this approach is necessary to ensure its direct costs are recovered. [Telstra, 20/9, Part 3, pp.6-7]

971. Adam disputes that significant project management tasks are undertaken in the early stages following a MNM order. Adam submits that the proposed standard cancellation charge will recover the costs associated with any such work in any case. [Adam, 1/10, Part 4. p.5]

972. Telstra submits that the pre-jumpering cancellation charge for 2007-08 should be increased from $23.60 to the average of the single visit MNM charges applying in 2007-08. Further, this charge should be payable regardless of when the number of services to be connected is varied. [Telstra, 20/9, Part 3, pp.6-7] Again, this is considered necessary to ensure direct costs are recovered, and other of the subsection 152CR(1) criteria are satisfied. [Telstra, 20/9, Part 3, pp.7-8] Telstra disputes Adam's view that pre-jumpering is inefficient. Telstra considers the cancellation charge following pre-jumpering should remain. [Telstra, 2/10, Part 3, p.2]

973. Adam objects to paying a cancellation charge to reflect pre-jumpering costs. In its view, pre-jumpering is done at the election of Telstra and is not an efficient practice. In the alternative, Adam suggests that the final determination drafting be varied to make clear that no such charge is payable where the pre-jumpering takes place more than 20 days from the cutover date. [Adam, 20/9, Part 2, pp.16-17] Adam disputes that an increase in the pre-jumpering charge is necessary to recover Telstra's costs of MNMs. It point to other MNM charges that it considers are being set above efficient cost levels to say that overall Telstra will be able to recover its MNM-related costs. [Adam, 1/10, Part 4, p.5]

974. Adam also considers that cancellation charges should be less than proposed, reflecting its view that the efficient labour cost associated with MNM planning is less than has been proposed. [Adam, 20/9, Part 2, p.17] Adopting Adam's proposed labour rate would reduce the standard cancellation charge by around $55 per cancelled MNM.

Commission's views

975. The Commission has maintained its proposed approach to the standard cancellation charge. This charge is to apply only where the entire MNM scheduled for an exchange is cancelled. It is payable regardless of when the MNM is cancelled.

976. The Commission does not accept that it is necessary for this charge to be specified on a per unit basis, or that it be payable whenever the number of services to be connected as part of a MNM is reduced, in order to ensure Telstra recovers its costs. The Commission is satisfied that this approach allows Telstra's efficient back-of-house costs to be recovered in the case of cancelled MNMs, or MNMs that proceed with fewer services. Telstra describes its planning costs as largely fixed in nature. These costs will be recovered either from the standard cancellation charge or from the two-part tariff specified with respect to MNM connection charges. And so, the Commission retained the structure of the standard cancellation charge it proposed.

977. As noted previously, the Commission acknowledges that Telstra's IDS labour costs are high compared to the surveyed salaries of telecommunications customer service

workers. However, at this time, the Commission is reluctant to accept that this survey provides an accurate benchmark of the forward-looking salary cost for IDS staff. And so, the Commission has maintained the level of the standard cancellation charge that it proposed to the parties.

978. The Commission's views on whether 'two-stage' (pre-jumpering followed by cutover) or 'single-stage' MNM processes should be adopted as the efficient MNM process are provided previously. At this stage, the Commission does not accept that it should disallow pre-jumpering charges as inefficient practice, but it will give further consideration to the issue should it arise in future to ensure that this approach remains appropriate having regard to access seekers' and contractors' preferences between single and two stage MNM processes.

979. The Commission has increased the 2007-08 charge for cancellations following pre-jumpering to reflect the simple average of charges that contractors impose in this instance. Unlike the case with MNM connection charges, the proposed allowance was below the simple average of the various prices that could apply. And so, it is considered necessary to better ensure that Telstra's costs will be recovered. This results in a 2007-08 charge of $24.10. Indexing this provides a charge of $25.10 for 2008-09. The Commission does not consider that the potential for other MNM charges to exceed underlying efficient costs means that this particular charge should not be increased.

980. However, these charges are only payable where the cancellation occurs after pre-jumpering having taken place within 20 business days of the scheduled cutover date. The 20 business day condition reflects the view that it would not be necessary for an access provider to pre-jumper earlier than this. The Commission has adopted the drafting proposed by Adam and Telstra in this regard.

981. This approach leads to a (entire) MNM cancellation charge of $126 in 2005-06 (indexed for later years), and a 'cancel following pre-jumpering charge' of $23.60 per relevant service until 1 June 2007, and $24.10 per relevant service following this time (indexed for later periods).

4.3.9 Pre-requisites to ordering a MNM and minimum MNM connection charges

Introduction

982. The Commission proposed to the parties that there should be a minimum charge payable for all MNMs, and that this should be based upon the cost of a MNM involving 20 services. However, the Commission proposed that there should be no minimum number of services to be connected before a MNM process could be requested. This reflected the view that access seekers are best placed to determine on the basis of the time and cost associated with a MNM process whether it would be preferable to request a MNM.

Parties' submissions

983. Telstra submits that it would be unreasonable not to specify a minimum number of services as a pre-requisite to requesting a MNM. Telstra submits that it incurs significant fixed costs in relation to a MNM, and not imposing a minimum number of services would be inconsistent with this. [Telstra, 20/9, Part 3, pp. 3, 7]

984. Telstra submits that 30 services should be the minimum scale for a MNM process to be used and that minimum exchange charges should reflect the cost of a MNM of this scale. Telstra states that there is unlikely to be demand for MNMs that involve fewer

services than this given the much longer lead times involved. [Telstra, 20/9, Part 3, pp. 3, 7]

985. Adam submits that minimum exchange charges should be based on a 10 service MNM. [Adam, 20/9, Part 2, pp.16-17] Adam considers this promotes competition, by removing obstacles to efficiently migrating services to the LSS. [Adam, 1/10, Part 4, p.6] Adam disputes that basing minimum exchange charges on a higher number of services is necessary to ensure that project management costs are recovered, as these costs are largely fixed and MNM connection charges will recover them. [Adam, 1/10, Part 4, p.6]

986. Adam also considers the final determination should make clear that this charge is not simply an additional charge that is payable in all cases, but only operates to increase per exchange charges to the minimum specified where they would otherwise be less than this. [Adam, 20/9, Part 2, pp.16-17] Telstra considers this to be unnecessary. [Telstra, 1/10, Part 3, p.3]

Commission's views

987. The Commission has decided to maintain the position proposed to the parties.

988. The Commission considers that 20 services is an appropriate scale for MNMs to be requested, as the connection of this number of services can be performed at less cost when done as part of a MNM. This is demonstrated by comparing the cost of 20 connections (as per the cost model for LSS MNMs) ($752.50) to the costs associated with making 20 LSS 'single' connections.

989. This is not to say that access seekers will always request a MNM for this number of connections at an exchange. As Telstra notes, they may prefer the shorter connection timeframes offered by 'single' connection processes.

990. The Commission has not specified a minimum number of connections to qualify for a MNM. The Commission considers that access seekers should have flexibility to request a MNM even if there are fewer then 20 services to connect if this is the approach that they consider preferable. However, access seekers will still pay for the MNM as though they were connecting 20 services given the specification of the minimum charge.

991. The approach taken to setting MNM connection charges means that Telstra's 'largely-fixed' back-of-house costs will be recovered in all instances. This is because of the inclusion of a fixed amount within MNM connection charges, including the minimum MNM charge, to recover this fixed cost component.

Assessment against subsection 152CR(1) criteria

Paragraph 152CR(1)(a)

992. In terms of the subsection 152CR(1) criteria, the Commission considers that this approach promotes the long term interests of end-users. (paragraph 152CR(1)(a)). It promotes competition, by removing obstacles to service providers migrating services to the LSS, and migrating services at the efficient, forward-looking cost. LSS-based supply will allow service providers greater ability to differentiate the price and quality of downstream DSL services they offer to end-users, increasing the level of competitive rivalry in the supply of DSL services.

993. Reducing the minimum charges to reflect an MNM involving ten services would not lead to a material increase in competition, as at the connection prices that have been specified for MNM and 'single' connections, and the differing connections timeframes, access seekers would be unlikely to request MNMs at this scale.

994. The minimum scale of MNMs will not affect any-to-any connectivity. Nor are the matters identified in paragraph 152AB(6)(a) relevant to this issue.

995. Economic efficiency in use of and investment in infrastructure used to provide listed services requires consideration of Telstra's infrastructure as well as the infrastructure of LSS access seekers. Restricting MNM processes to larger scale migrations, when MNM processes can result in more efficient outcomes for smaller scale migrations, would tend to discourage otherwise efficient use of and investment in infrastructure used to provide the LSS and downstream DSL services.

996. This is because those restrictions would delay MNMs completing (until sufficient demand is accumulated within the exchange) or prevent existing services being migrated to the LSS at least cost. Uncertainty or delay will discourage take up of the LSS, and use of Telstra's LSS ordering systems, as well as discourage efficient investment in access seeker's DSLAMs.

997. This approach satisfies Telstra's commercial interests, including its interest in recovering direct costs, and exploiting economies of scale and scope. The minimum MNM exchange charges, and MNM connection charges, permit Telstra to recoup the costs associated with MNMs. By better aligning the charge for smaller scale migrations with cost, and thereby promoting competition, dynamic efficiencies will be encouraged. These in turn will stimulate demand for LSS and downstream LSS, generating economies of scale and scope across Telstra's production processes. Telstra is able to exploit these economies.

Paragraph 152CR(1)(b)

998. The next criterion involves Telstra's legitimate business interests, and its investment in facilities used to provide the LSS. (paragraph 152CR(1)(b)) These matters are discussed as part of the first criterion. A minimum scale of 30 services for a LSS MNM is not necessary to satisfy these interests.

Paragraph 152CR(1)(c)

999. The next criterion involves the interests of all persons who have rights to use the LSS. (paragraph 152CR(1)(c)) The Commission's approach is consistent with access seekers' interests in being able to compete in downstream markets on the basis of the price and quality of the services they can offer. A minimum scale of 10 services is not necessary to satisfy these interests, as it would be quite unlikely that a MNM of this scale would be requested.

Paragraph 152CR(1)(d)

1000. The next criterion concerns the direct costs of providing access to the LSS. (paragraph 152CR(1)(d)) In this context it calls for consideration as to whether Telstra can recover the costs of smaller scale MNMs. Telstra will be able to do so under the pricing structure that has been adopted regardless of the approach taken to minimum scale.

Paragraphs 152CR(1)(e) & (f)

1001. The Commission does not consider that minimum MNM charges that are higher than those it proposed, or a minimum number of services as a MNM pre-requisite, are necessary to promote safe and reliable operation of the network or facilities, or to ensure the recovery of costs Telstra has incurred in making any enhancements that MNM processes may represent. (paragraphs 152CR(1)(e)-(f))

Paragraph 152CR(1)(g)

1002. The Commission considers that the economically efficient operation of carriage services and associated networks and facilities of the access provider and access seekers will be encouraged by smaller-scale migrations utilising MNM processes. (paragraph 152CR(1)(g)) This is because it will promote competition in downstream services by removing obstacles to connecting the LSS, while ensuring that efficient costs of connecting the LSS is able to be recovered. Greater competition in the supply of downstream DSL services will encourage efficiency in the supply of those services.

1003. The Commission accepts Telstra's advice that clarification around when the minimum exchange charge is payable is unnecessary. The Commission notes that the minimum exchange charge term is intended to operate to specify a minimum charge payable per exchange. If the charges applicable to a MNM at an exchange fall below this level, the minimum-charge term operates to increase the charges payable for that MNM to the minimum amount.

4.3.10 Commencement date, expiry date and interest

1004. The Commission has backdated the LSS MNM connection charges. The balance of the terms that the Commission has specified in relation to LSS MNMs will commence when the final determination comes into effect. These terms are to apply until 31 July 2009. Interest is payable on any over-payment that has occurred. The term of backdating, and reasons for this approach, are discussed previously.

4.3.11 Changes to draft final determination

1005. The parties made suggestions around the drafting of the FD. Telstra submits that the terms should be integrated into the structure of the exiting commercial agreement. In particular, Telstra considers that the definition used of a MNM should reflect the definition used in the commercial agreement. Telstra also submits that the charges should be expressed as GST exclusive prices. [Telstra, 20/9, Part 3, p. 2] Adam objects to the MNM definition being changed as Telstra suggests, noting that using this definition would restrict the MNM terms to situations where a minimum of 50 services are ordered as part of a MNM. [Request, 1/10, Part 4, p.1]

1006. Adam's drafting suggestions are discussed previously in sections 4.3.8 and 4.3.9 of these reasons. [Adam, 20/9, Part 2, pp.17-18]

1007. Some of the terms specified in the FD differ to some extent to those proposed at the draft determination stage. These changes reflect the revised expiry date for the determination, and approach to backdating for the MNM connection charges. Reasons for these changes are discussed previously. Also, the prices are expressed as being GST exclusive. Further drafting changes were made to make clear when the pre-jumper cancellation charge can be imposed. These changes reflect the suggestions of Telstra and Adam.

1008. The Commission has not altered the terms of the final determination to make clear that the minimum exchange charge is not simply an additional charge to be imposed in all cases. Telstra has advised such a change is unnecessary to ensure the minimum exchange charge is not applied in this way.

1009. Nor has the Commission adopted the definition of MNM that Telstra proposed, as this definition includes elements (such as the minimum number of services) that the Commission considers inappropriate. The Commission notes that the operative clauses of the final determination provide further detail around the type of MNM to which they apply.

ATTACHMENTS: LSS annual charge cost model

LSS ‘single’ connection and disconnection cost model

LSS MNM cost model