17 May 2010

Mr Robert Wright
General Manager
Communications Group
Communications and Regulatory Operations Branch
Australian Competition and Consumer Commission

By email: robert.wright@accc.gov.au

Dear Mr Wright

Telecommunications Access Pricing Principles for Fixed Line Services

The ACCC's current review of access pricing principles is both highly significant and timely. It has been clear for some time that application of the current "TSLRIC" approach leads to increasing prices for access to Telstra's fixed line network which are simply not justified, since it compensates Telstra for costs it never incurred nor will incur. The ACCC's current review represents a valuable opportunity to introduce a much-needed change to the regulatory regime, end the current competitor-funded subsidy to Telstra and provide consumers with the competitive, fairly-priced services the access regime was always meant to deliver.

However, true to form it appears that Telstra is using this review as another avenue to raise access prices by seeking to entrench a high-cost methodology, albeit under the guise of a new approach. Telstra has proposed that its network should be valued using a methodology known as depreciated optimised replacement cost (or DORC). This appears to be a welcome departure from the current regime and DORC has been proposed as an alternative approach by Optus in the past. The appearance is misleading, however, since Telstra argues that the DORC value should be measured in a particular way:

> *"TSLRIC… determines the value of Telstra's regulated assets: the present value of the TSLRIC stream of payments over their remaining life."* [1]

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[1] Telstra, February 2010, *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services, Telstra's Response to the ACCC's Discussion Paper*, pp.23-24

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This means that access prices would depend upon a "TSLRIC" network valuation, just as they do today. Whilst Telstra's proposal might appear to support reform, in substance it is little more than a re-badging of the ACCC's existing pricing approach (albeit with some relatively minor changes which reflect differences in remaining network asset lives) and would clearly fail to represent a reasonable interpretation of the DORC methodology.

Under the existing TSLRIC approach, network assets are valued using a "hypothetical cost model" (such as Telstra's TEA model). The Australian Competition Tribunal has criticised the use of such models in a judgement released today which rejects an Undertaking by Telstra (an attempt to double the price of access to Telstra's Unconditioned Local Loop Service or ULLS). The Tribunal's view was that a price estimated by Telstra's TEA model:

> *"would not encourage the economically efficient use of Telstra's network..."*
>
> *"would not encourage efficient investment by access seekers..."* and
>
> *"[would not] reflect Telstra's legitimate business interests, which are to receive a commercial return on its prudent (past) investment in the infrastructure used to supply the ULLS, not a hypothetical new investment..."*

The Tribunal's statements underline the fact that Telstra's proposal is fundamentally at odds with the pro-competitive principles enshrined in the ACCC's governing legislation. It would give Telstra revenue that bears no relation to actual costs incurred. Instead Telstra's model costs a hypothetical new investment that will never actually be made.

Further, Telstra intends to charge customers based on the fiction that its fully depreciated copper network is a brand new asset. The reality of business is that depreciated assets cannot generate the same value as newly constructed assets – to pretend otherwise would amount to special treatment for Telstra that is neither reasonable nor fair. Telstra's scheme fails to reflect past compensation and would allow it to recover network costs many times over by overcharging its competitors and their customers. Optus believes that Telstra should be able to recover the cost of its actual prudent investment – but no more.

On a practical note, the hypothetical cost models on which Telstra's proposal depends are complex and their assumptions are highly contentious, frequently leading to prolonged dispute. Adopting Telstra's method could only create further litigation.

Finally, the impact of Telstra's strategy would reach well beyond its competitors: it would result in significant price rises for retail broadband and telephony products. Under Telstra's plan, consumers would pay inflated rates for service across Telstra's copper which could well be higher than the rates they will be paying for high-speed services across NBNCo's optical fibre. Telstra's proposal is clearly detrimental for competition and for consumers.

Fortunately, there are a number of more appropriate alternatives to Telstra's pricing proposal. For example, Optus has proposed a pricing method that is simple, transparent and fair to all sides. The 'depreciated actual cost' (DAC) method reflects Telstra's actual costs incurred, with fair allowance made for the compensation which Telstra has already received. The use of a DAC valuation for Telstra's assets would allow it to recoup a reasonable rate of

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return on its investment. There are precedents from other utility industries for the use of DAC and the information required for its use can easily be extracted from Telstra's regulatory accounts.

In summary, I consider the ACCC's current review of access pricing principles to be an invaluable opportunity to reform the pricing of access to Telstra's fixed line telecommunications network, and to deliver genuine competition for the benefit of end users. Telstra's pricing proposal is aimed squarely at destroying that opportunity, by perpetuating the discredited "hypothetical cost model" approach to access pricing.

Optus urges the ACCC to reject Telstra's pricing proposal.

Yours sincerely

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