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Submission in Response to Draft Pricing Principles and Indicative Prices for LCS, WLR, PSTN OTA, ULLS, LSS

Macquarie Telecom Pty Limited ("**Macquarie**") welcomes the opportunity to make a submission in response to the matters raised in the Australian Competition and Consumer Commission's ("**ACCC**") report on draft pricing principles and indicative prices concerning fixed services.[1] The Draft Decision has been greatly anticipated by operators in the telecommunications industry. This anticipation follows the ACCC's decision to commission a fixed services cost model, the extensive consultation process concerning the cost model and the critical importance of the Draft Decision to provide guidance to operators in relation to negotiations over agreements for the supply of fixed services.

This submission addresses the following matters arising from the Draft Decision:

- Late release of the Draft Decision;
- Harm to investor confidence;
- Review of costing methodology for fixed network services;
- Period of pricing principles and indicative prices;
- Weighting of benchmark prices;
- Application of adjustment path pricing;
- Two tiered pricing for ULLS and WLR; and
- Single national rates for PSTN OTA, LCS and LSS.

1. Late Release of the Draft Decision

Macquarie wishes to record its disappointment at the late timing of the release of the Draft Decision. The ACCC's previously reported indicative prices for fixed services were effective until 31 July 2009. Macquarie believes that the ACCC should have ensured that new prices were set prior to the expiry of the previous indicative prices. Access seekers required new prices because existing agreements for the supply of fixed services terminated on 31 July and were being re-negotiated prior to this date.

[1] Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS, ACCC, August 2009, ("**Draft Decision**")

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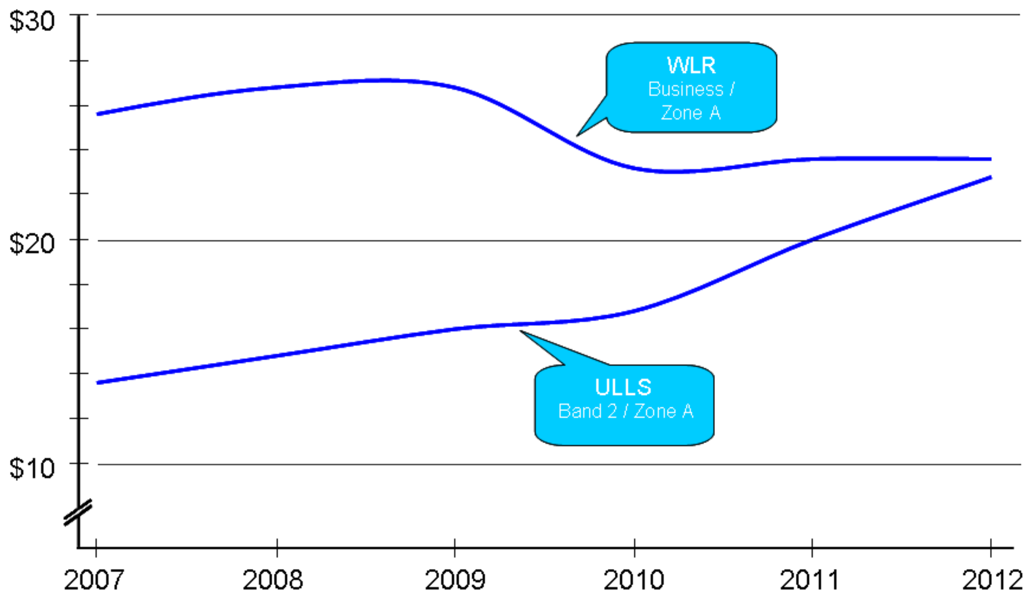
The late timing of the Draft Decision placed access seekers at a significant disadvantage in their negotiations with Telstra as they had no guidance on prices. It is of great concern to Macquarie that this situation arose especially as the ACCC was well aware of upcoming re-negotiations and had provided assurances to access seekers that indicative prices would be available in sufficient time to assist in commercial negotiations.

Macquarie accepts that the task of setting indicative prices for fixed services is inherently complex and has required considerable effort by the ACCC. Moreover, there is an on-going threat of challenge to the ACCC's decisions which results in it "treading carefully" in its decision making processes. However, Macquarie is of the view that the ACCC has a fundamental responsibility to promote effective competition. By not producing new indicative prices for fixed services in time for supply agreement negotiations, the ACCC failed to fulfil its basic responsibility which resulted in an enormous disservice to access seekers.

2. Harm to Investor Confidence

Macquarie contends that the Draft Decision signals to the market a clear change in direction of regulatory policy which fundamentally harms investor confidence. In particular, Macquarie is concerned with the significant increase in the indicative price of the ULLS and the elimination of the price differential between ULLS and WLR. The comparative indicative prices for these services between 2007 and 2012 are shown below in Figure 1.

Figure 1 WLR and ULLS Comparative Indicative Prices 2007 - 2012



Source: Draft Decision

As shown in Figure 1, the price differential between WLR and ULLS will be eliminated if the Draft Decision is adopted. This is primarily driven by the increase in the ULLS price. Macquarie appreciates that the draft indicative prices for the three years 2010 to 2012 are derived from a different model to that which was used to derive the previous indicative prices. Nonetheless Macquarie finds it difficult to understand how it can be that the price differential between WLR and ULLS can fall from more than $12 in 2007 to $0.20 in 2012. At the very least, Macquarie believes that the ACCC owes the industry an explanation.

For many years, the ACCC has made it clear that it believed in facilities based competition as the best path to sustainable competition. This resulted in the ACCC focusing its efforts on ensuring availability of the ULLS on reasonable prices.[2]

Access seekers responded to the ACCC's signals and pricing decisions and made appropriate investments. This resulted in a sudden carrier uptake of ULLS. In its recent report on competitive safeguards, the ACCC commented on the success of its ULLS strategy noting that:

> *"For the second time in two years, uptake of both line sharing service (LSS) and unconditioned local loop service (ULLS) lines doubled, with over a million unbundled services being in operation in June 2008, reaching a total of 1.1 million by December 2008."* [3]

Despite this success, the Draft Decision marks the apparent abandoning of the ACCC's ULLS strategy. As set out in the Draft Decision:

- the ULLS price will <u>increase</u> while the prices of all other fixed services will <u>decrease</u>; and
- the ULLS price increase is substantial, e.g., ULLS prices in CBD areas will increase more than 3.5 times over three years.

Faced with this shift in the ACCC's position on ULLS, the confidence of operators like Macquarie to invest in the telecommunications industry has been severely harmed. Inevitably, the response of operators to the substantial ULLS price increase will be to pass on price increases to end users and, if this is not successful, to withdraw from this activity. Macquarie believes that the ACCC's draft ULLS indicative prices are too high and, as such, the ACCC should revisit its draft decision on ULLS prices.

<u>3. Review of Costing Methodology for Fixed Network Services</u>

In the Draft Decision, the ACCC notes concerns with the TSLRIC+ methodology which has been adopted by the ACCC for the determination of indicative prices for fixed services. In particular, the ACCC raises concerns with the TSLRIC+ method of sunk infrastructure valuation, i.e., optimised replacement cost ("**ORC**") and notes that there are several alternative valuation approaches. The ACCC also notes that it is likely to explore this matter with industry through a discussion paper. Macquarie supports and encourages the ACCC to research alternative valuation approaches and to report on this in a discussion paper. However, in the meantime, Macquarie wishes to comment on the matter of cost methodology as raised in the Draft Decision.

Macquarie believes that it is appropriate to reassess the valuation of sunk infrastructure, i.e., infrastructure for which the investment cost cannot be recovered, for access pricing purposes. This is because continuing to value Telstra's network using ORC results in access pricing at levels which continue to compensate and reward Telstra for its past investments which have no alternative use and which have already been recovered. While ORC may be

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[2] Critical Regulatory Issues for a Competitive Broadband Market, Graeme Samuel, Broadband Australia 2006 Conference, 30 November 2006
[3] Telecommunications Competitive Safeguards 2007-2008, ACCC, April 2009

appropriate where investment costs may be recovered and applied to alternative uses, the approach is not effective where investment costs are sunk and the investment is in bottleneck facilities which cannot be replicated.

Macquarie's views on the alternative asset valuation approaches raised by the ACCC are summarised in Table 1 below. Macquarie has assessed these on the basis of two factors:

- whether or not the valuation approach will result in a decreasing valuation of assets over time as per the ACCC's assumption[4], and
- whether or not the valuation approach has regulatory precedent.

Table 1: Assessment of Alternative Asset Valuation Approaches

Asset Valuation Approach	Lower Valuation?	Regulatory Precedent?	Outcome
Historic cost / actual cost	No. Asset values are fixed.	No.	Reject. Does not achieve desired outcome.
Depreciated Historic cost / actual cost (DHC/DAC)	Yes. Asset values decrease in accordance with periodic depreciation charges.	Yes. Ofcom has used DHC.	Consider adopting. Meets desired outcome and has regulatory precedent.
Optimised replacement cost (ORC)	No. Assets values are reset each period. Practical experience shows that asset values increase.	Yes. Widely used.	Reject. Does not achieve desired outcome.
Current Replacement Cost	No. Assets values are reset each period. Practical experience shows that asset values increase.	Yes.	Reject. Does not achieve desired outcome.
Depreciated optimised replacement cost (DORC)	Yes. Assets values reflect the exhaustion of service potential over time.	Yes.	Consider adopting. Meets desired outcome and has regulatory precedent.
Derived from existing prices	No. Asset values are fixed.	No.	Reject. Locks in existing prices.

Source: Macquarie analysis

Macquarie's overall assessment of the alternative valuation approaches is that only DHC/DAC and DORC satisfy the basic requirements of achieving a lower asset value over time and having regulatory precedent. All other valuation alternatives fail both or one of these requirements.

Macquarie understands that DORC results in lower asset values than ORC on the basis that the fundamental difference between DORC and ORC is depreciation. However, this outcome is dependent on the construction of DORC from ORC. Macquarie notes that this is not without its complexities.

[4] ACCC, Draft Decision page 16

Macquarie's view is that depreciation using DORC is proportional to historic cost depreciation. That is, if under historic cost assets were written down by 25 *per cent*, then asset values under DORC would also be written down by 25 *per cent*.

It is evident that DORC carries with it the problems and weaknesses of ORC. In particular, key concerns with ORC are:

- the over valuation of assets (and ultimately prices) as it reflects value changes which are not driven by changes in actual costs; and
- extensive subjective judgements about a range of factors including network design, patterns of demand and pricing paths.

By contrast, DHC / DAC does not face these problems. DHC / DAC is relatively simple and objective. There would be no concern about determining initial asset values, depreciation or asset optimisation. On this basis, Macquarie advocates that DHC / DAC should be adopted by the ACCC as an alternative asset valuation methodology to ORC.

4. Period of Pricing Principles and Indicative Prices

The ACCC intends to adopt pricing principles and indicative prices for fixed services for three periods, i.e., the ten month period ending 30 June 2010, and the years ending 30 June 2011 and 2012. Macquarie is of the view that this time frame is simply too long and that pricing principles and indicative prices should only be set at this time for the period ending 30 June 2010.

Macquarie acknowledges that setting prices for the period that the ACCC intends is consistent with providing investors with certainty. However, Macquarie believes that there are a range of factors in the current environment which indicate that it would not be appropriate to set prices beyond the period ending 30 June 2010. That is, such factors outweigh the pricing certainty that the ACCC's proposed approach would provide.

The relevant factors that support the setting of pricing principles and indicative prices at this time for only the period ending 30 June 2010 are given below.

- As noted above, the ACCC acknowledges that there are concerns with the TSLRIC+ pricing principle and that it is likely to explore this with industry through a discussion paper. Macquarie contends that it is not appropriate for the ACCC to set indicative prices on the basis of a pricing principle with which it has concerns and is likely to engage in discussions with industry with a view to finding an alternative.
- The industry is on the cusp of undergoing a period of significant and unprecedented change which is likely to impact on fixed service prices. Such potential changes include the granting of new powers to the ACCC to determine price and non-price conditions of access and a commitment to separate Telstra's wholesale and retail businesses.

5. Weighting of Benchmark Prices

Macquarie notes that for four of the five fixed services, the ACCC has set indicative prices with regard to two inputs:

- the Analysys cost model; and
- international benchmark prices.

Table 2 below shows for each of these services the range of indicative prices, the range of costs from the Analysys cost model and benchmark prices.

Table 2: Fixed Services by Indicative Prices, Model Costs and Benchmark Prices

Service	Indicative Prices 2009-10 – 2011-12	Analysys Model Costs 2009-10 – 2011-12	Benchmark Prices
ULLS	$16.60 – 23.60	$23.03 – 22.54	$13.00 – 17.00
LCS	13.3 – 7.9 cents	7.8 – 7.8 cents	7.0 – 10.56 cents
WLR	$23.30 – 23.80	$23.26 – 23.76	$20.51
PSTN	0.9 – 0.8 cents	0.74 – 0.79 cents	0.78 – 0.75 cents

Source: Draft Decision

The relatively wide range of indicative prices for ULLS, LCS and PSTN reflects the "adjustment path" which has been adopted for the prices of these services. As such, the prices and costs at the end of the range can be more accurately compared. On this basis, the data in Table 2 shows that the extent to which indicative prices have been determined with regard to the Analysys model costs relative to the benchmark prices differs. In particular, benchmark prices have been given significantly less weighting for ULLS and WLR.

As noted above, the ULLS indicative prices have increased whereas the prices for all other services have decreased. Macquarie believes that this outcome indicates very clearly that the ACCC has not placed appropriate weighting on the benchmark price for the ULLS. Macquarie contends that the ACCC should revisit its ULLS indicative prices in this context. For the avoidance of doubt revised ULLS indicative prices should also be subject to an adjustment path if it is likely that there will be a price shock.

6. Application of Adjustment Path Pricing

Macquarie notes that the ACCC has adopted an adjustment path for three services, i.e., LCS, ULLS (Zone A) and PSTN OTA. These are summarised below in Table 3.

Table 3: Previous and Proposed Indicative Prices by Service with Adjustment Path

Service	Previous 2008-9	Proposed 2009-10	Proposed 2010-11	Proposed 2011-12
LCS	17.36 (All Areas - cents)	13.30 (All Areas - cents)	10.20 (All Areas - cents)	7.90 (All Areas - cents)
ULLS	$6.60 (Band 1) $16.00 (Band 2)	$16.90 (Zone A)	$20.00 (Zone A)	$23.60 (Zone A)
PSTN OTA	1.0 (Headline rate – cents)	0.90 (All Areas - cents)	0.85 (All Areas - cents)	0.80 (All Areas - cents)

Source: Draft Decision

The ACCC justifies "adjustment path" pricing for these services to prevent "price shocks" for both the access seeker and the access provider. Macquarie believes that a "price shock" should be assessed in terms of the change in revenue / cost that will result and not merely by the extent to which the price has moved *per se*. While Macquarie may accept that an adjustment path may be justified it is important to consider the materiality of the change in price in revenue/cost terms, who will be paying the indicative price and the competition implications of "immediate" compared to "adjustment path" pricing. Macquarie's views on adjustment path pricing in respect of each of the three services are discussed below.

6.1 LCS

In the case of LCS, Macquarie notes that this service is effectively only provided by Telstra. Macquarie submits that the proposed adjustment path pricing is not justified for the following reasons:

- there is no "price shock" because the current agreed prices for LCS are already below that of the proposed indicative price, as such, adopting the adjustment path prices would result in a price increase rather than a price decrease for this service;
- Telstra would not suffer any harm if the lower end price (7.9 cents) was adopted immediately as the revenue loss that it would incur would be negligible relative to Telstra's fixed service revenue base; and
- immediate lower input costs would (at least in part) be shared with end users which would be consistent with promoting competition.

6.2 ULLS

In the case of ULLS (Zone A), Macquarie notes that this service is effectively only provided by Telstra. Given that the adjustment path is upward, this means that the effect of the adjustment path is *ceteris paribus* advantageous to access seekers. Leaving aside the detrimental impact of the proposed pricing of ULLS *per se*, as discussed above in section 2, Macquarie submits that adjustment path pricing in this case is justified for the following reasons:

- the ULLS price increase will have a material detrimental impact on access seekers through significant additional costs which are ameliorated by the adjustment path;
- the price increase will force access seekers to pass on price increases to end users and ultimately out of supplying those services to end users which involve ULLS; and
- there is considerable risk that there would be a detrimental impact on end users if access seekers were forced to withdraw service on economic grounds in the short-term. That is, adjustment path pricing will assist access seekers to orderly exit this activity and thereby minimise the impact on end users.

Macquarie considers that despite the adjustment path the price increase in the case of the former Band 1 ULLS from ($6.60) to Zone A ULLS ($16.60) is severely detrimental to access seekers. That is, despite there being an adjustment path the price increase is $10 which represents an increase of over 150 *per cent*.

Because of the significance of this increase, Macquarie believes that a separate adjustment path for the former Band 1 ULLS should be adopted under which the adjustment path is smoothed. That is, two adjustment paths should be adopted:

- Zone A services which were formerly Band 1 services; and
- Zone A services which were formerly Band 2 services.

The prices that would apply to these adjustment paths would be determined after making appropriate adjustments to increase the weighting of benchmark prices (refer to discussion in section 5) and moving to a four tiered pricing structure (refer to discussion in section 7).

6.3 PSTN OTA

In the case of PSTN OTA, Macquarie notes that this service is reciprocal in nature being provided and sought by Telstra and access seekers alike. As such, the competitive impact of "immediate" pricing opposed to adjustment path pricing is neutral and is of negligible materiality.

Macquarie believes that there is no price shock because current prices for PSTN OTA are actually already below the draft indicative prices. This means that the short-term impact of the adjustment path price is actually a price increase rather than a price decrease. Accordingly, Macquarie believes that the proposed adjustment path pricing is not justified in the case of PSTN OTA.

7. Two Tiered Pricing for ULLS and WLR

The pricing structure of the draft indicative ULLS prices involves a shift from four geographic based bands to two geographic based zones. The band structure is a legacy from Telstra while the zone structure is derived from the ACCC's cost model. In the case of WLR, the shift in the pricing structure is from a business - residential dichotomy to two geographic based zones. ULLS and WLR are discussed in turn.

7.1 ULLS

Macquarie is opposed to the two tiered pricing structure for the ULLS as proposed by the ACCC. Macquarie submits that the ACCC's pricing structure will create significant distortions because it averages costs across geo-types with very different cost structures. Contrary to the view expressed by the ACCC in the Draft Decision, the empirical evidence from the Analysys cost model demonstrates:

- that geo-types 1 - 11 are not homogenous in relation to cost; and
- that there would be a significant reduction in the distortion caused by cost averaging by moving to a four tiered pricing structure.

The proposed move to a two tiered pricing structure for the ULLS is a significant reversal of long standing regulatory policy by the ACCC for which it provides limited reasoning and empirical support. As noted in the Draft Decision there has been a long industry debate regarding geographic averaging of access pricing. The ACCC has on all previous occasions supported geographic de-averaging and has indicated prices for the ULLS based on a four tiered structure.

The ACCC has previously rejected Telstra's geographically averaged prices because, as noted in the Draft Decision, they could "distort competitive outcomes when there are significant divergences in underlying costs across regions".[5] The distortion arises because prices that deviate significantly from cost distort decisions to use the access services efficiently. That is, where prices are set above cost due to averaging there will be too little consumption of the service, and *vice versa* when prices are set below cost due to averaging.

[5] Draft Decision, p20

The ACCC has previously indicated that it believes a de-averaged approach based on four tiers of ULLS pricing is more directly cost reflective and would provide a more appropriate basis for build or buy decisions. In its Draft Decision the ACCC has changed its view. This is a significant change in policy as the actual cost differences between areas or geo-types will not have changed. In making this change, the ACCC has relied on evidence from the Analysys cost model which it says indicates that the cost structures of the geo-types in each of its two tiers (or zones) are sufficiently homogenous to not distort build/buy incentives at a sub-tier (or sub-zone) level. In determining the zones, the ACCC includes geo-types 1 to 10 in Zone A on the basis that they share similar characteristics, and "by aggregating them into a single zone it is considered that they would not provide a distortionary effect on investment or competition".[6]

Contrary to the view expressed by the ACCC in its Draft Decision, the geo-types it groups to form its two tiered pricing structures have very different cost structures. That is, despite the claim by the ACCC that its tiers are defined by similar characteristics - the numbers of locations per kilometre of road and similar population density - the modelled costs are very different.

Having taken the view that a four tiered pricing structure is appropriate for ULLS, Macquarie has then sought to determine the optimal grouping of geo-types. Macquarie has determined this by an iterative approach which minimises the distortions between the cost for each geo-type and the average price across different geo-type groupings. Specifically, Macquarie has calculated the sum of squared differences between the averaged price of a geo-type group and the cost of each geo-type (the optimal grouping is the one that minimises this amount). The outcome of this approach is summarised in Table 4 below.

Table 4: Optimal Four Tiered Cost Structure for ULLS

Tier	Geo-types	Monthly Cost (in 2012)
1	1-2	$3.30
2	3-6	$20.29
3	7-11	$36.55
4	12-14	$70.86

Source: Macquarie analysis using Analysys cost model

Macquarie believes that the costs shown in Table 4 are the relevant output from the Analysys cost model that should be used in the determination of ULLS indicative prices. That is, these costs plus the benchmark prices should be used to determine indicative ULLS prices.

7.2 WLR

The pricing of WLR is constrained by the retail price control arrangements which apply to Telstra. In the past, the ACCC has effectively adopted a flat pricing structure, i.e., a business - residential pricing structure in which prices are geographically independent. Going forward, the ACCC proposes a similar approach. This time the ACCC has set indicative prices for Zone A only and has declined to set a Zone B price.

Macquarie is of the view that a flat pricing structure for WLR is appropriate. This is because the geographic scope of competition in retail line rental (for which WLR is an input) is national in scale, with almost all competitors relying on Telstra's ubiquitous local loop services. In

[6] Draft Decision, p21

contrast, competition in broadband (for which ULLS is an input) is more geographic in nature, with competitors in some areas relying on cable and wireless networks. Unlike retail pricing of line rental, retail prices for broadband are geographically different – simply because DSL services are only offered in some areas and not in others. As such, geographic averaging of ULLS prices will create material distortions in consumption decisions, whereas averaging of WLR prices will not.

Macquarie feels that the ACCC needs to provide guidance for WLR prices in Zone B. Unless this is given, Macquarie believes that Telstra will insist on adopting as a price the Zone B cost provided by the Analysys cost model. Macquarie believes that this would be unacceptable. As such, Macquarie believes that a single national pricing structure should be adopted, i.e., Zone B should be bought into line with Zone A.

With regard to the level of prices, Macquarie believes that the ACCC has not given sufficient weight to benchmark prices. Accordingly, Macquarie is of the view that the nation-wide indicative prices for WLR should be clearly lower than $23.30.

8. Single National Rates for PSTN OTA, LCS and LSS

The draft indicative prices for LCS and LSS are single national rates. This approach is consistent with the previous indicative prices for these services. On the basis that the costs of providing these services are not significantly different between geographic areas, Macquarie supports the national rate pricing structure for these services.

In respect of PSTN OTA, the draft indicative prices have shifted from a two part (flag fall and minutes of use) and four tiered geographic based pricing structure to a single national rate. However, simpler pricing structures have been adopted in commercial agreements. Macquarie supports the simpler pricing structure of the draft indicative price for this service.

9. Summary and Closing

Macquarie appreciates the opportunity to respond to the Draft Decision. Macquarie has set out herein its views on various matters raised in the Draft Decision. In particular, the key points in this submission are:

- the ACCC should revisit its indicative prices for ULLS and WLR, particularly in respect of the weighting it has given to benchmark prices for these services;
- the ACCC should, at this time, only set pricing principles and indicative prices for the period ending 30 June 2010;
- Macquarie urges the ACCC to explore alternative asset valuation methodologies and to report on this in a discussion paper;
- Macquarie favours DHC / DAC as alternative to ORC;
- adjustment path pricing for LCS and PSTN OTA is not justified; and
- a four tiered pricing structure for ULLS should be adopted while a single tiered pricing structure for WLR should be adopted.

Macquarie would welcome an opportunity to discuss the matters raised in this submission with you. In the meantime, if you have any queries please feel free to contact me.

Yours sincerely

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