

RG 021003  
26 February 2010

The General Manager  
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Australian Competition and Consumer Commission

By email

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### **Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services**

Macquarie Telecom Pty Limited ("**Macquarie**") welcomes the opportunity to make this submission to the Australian Competition and Consumer Commission ("**ACCC**"). This submission is in response to the ACCC's discussion paper concerning the above.<sup>1</sup>

From Macquarie's perspective, the regulation and pricing of fixed line services in the Australian market has been unsatisfactory. While in the past there have been various reviews of fixed line service pricing and several fixed service cost models have been developed, competition in fixed services remains subdued. Macquarie believes that the ACCC's current review which contemplates a change in the approach for setting fixed line services prices is a much welcomed development and one that promises to remove some of the inequity in the existing pricing methodology which has constrained fixed service competition.

The issues raised in the Discussion Paper are inherently complex and on the basis of past experience, their resolution will not be met with a strong degree of industry consensus. Macquarie contends that the complexity of the ACCC's cost allocation regime and the resources required for its administration could be reduced through reform to industry structure. That is, the need for a complex fixed services access regime incorporating mechanisms for ensuring efficient expenditure and service quality would be obviated if Telstra was structurally (or functionally) separate.

Macquarie implores the ACCC to expedite this review. The industry requires urgent guidance from the ACCC on fixed line service pricing and cannot afford to be tied up in on-going processes with little decisive action being taken. Macquarie expects to ACCC to set out its timetable for finalising this review and implementing its outcomes in the very near future.

Macquarie has responded to each of the questions set out in the Discussion Paper. For ease of reference each question is reproduced in *italics* followed by Macquarie's response.

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<sup>1</sup>ACCC, Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services, Discussion Paper, December 2009 ("**Discussion Paper**")



*1. Whether locking in a value for the RAB, rather than the current approach of continually re-valuing the RAB, would create more certainty for access providers and access seekers, and in turn assist them in making efficient decisions regarding their future investment patterns and general business plans? Why/why not?*

Macquarie understands that a RAB would essentially consist of a list of fixed network assets with a corresponding monetary value as determined by the choice of alternative valuation approach. A locked-in RAB valuation effectively means a fixed gross asset valuation base which would be subject only to annual adjustments to account for new or replacement assets and the retirement of assets. The fixed gross asset valuation base would remain in place for a given regulatory period. A locked-in RAB would be in contrast to the ACCC's current approach by which the gross asset base is revalued each regulatory period on the basis of the replacement cost of the asset base.

A locked-in RAB is more certain than a revalued asset base because it is subject to fewer potential changes. That is, a locked-in RAB will change only by new or replacement assets and asset deletions while the revalued asset base will change in response to changes in the replacement cost of the asset base which in turn will reflect a wide range of potential changes including, for example:

- changes in technology which may mean that the replacement asset might be a different type of asset, e.g., digital equipment might replace analogue equipment;
- movements in the underlying inflation rate which *ceteris paribus* means increasing asset values;
- changes in labour costs where assets are constructed;
- the demand and supply for specific assets; and
- currency fluctuations where assets are purchased in foreign currency.

Macquarie values access pricing certainty very highly. If prices for access services are uncertain, the confidence of access seekers to make long-term investments in infrastructure is impaired. Macquarie believes that it would approach potential investments in infrastructure more positively if access prices were locked-in for a given regulatory period as this would remove an element of uncertainty in the investment decision.

*2. Whether the value of the RAB should be locked in or whether it should continue to be re-valued?*

The current approach of revaluing Telstra's fixed service asset base has resulted in continually higher valuations. This is because the value of such assets has continued to rise over time in spite of the ACCC's expectation that asset values would decline. This has meant that the prices of fixed services acquired by access seekers have been higher than expected and Telstra is compensated for costs over and above those costs that it has actually incurred.

The impact of revaluing fixed assets has been unfair to access seekers. As such, Macquarie believes that a locked-in value of the RAB should be adopted in the ACCC's costing methodology as opposed to a continually revalued asset base. As noted in Macquarie's response to question 1 a locked-in RAB will provide access pricing certainty and will therefore boost investor confidence.

*3. Whether there are any services for which a pricing approach that locks-in and rolls forward the RAB would not be appropriate? If so, what approach should be taken to pricing these services?*

Macquarie does not believe that there are any specific fixed services for which a locked-in RAB would not be appropriate. In taking this view, Macquarie notes that none of the fixed line services are expected to be subject to major by-pass and inefficient duplication.

*4. Whether a single RAB should be adopted for pricing the ULLS, WLR, PSTN OTA, LSS and LCS services? Why/why not? Which assets should be included in the RAB? Consider the layered nature of telecommunications service provision in your response.*

As noted in its response to question 1, Macquarie understands that a locked-in RAB would essentially consist of a list of fixed network assets with a corresponding monetary value. The appropriate cost of any particular fixed line service will include the annualized cost of the fixed network assets which are used to provide that service. As such, Macquarie envisages a single fixed services RAB from which the value of relevant assets are assigned by way of cost allocation rules to specific services. This would result in multiple sub-sets of the RAB consisting of asset values which would be relevant and appropriate for each specific service.

Macquarie understands that most of the fixed line services share some common network components. It follows that there is no need to start from a position of separate RABs because in allocating these common costs to derive individual service prices using cost allocation rules, sub-RABs will be effectively created.

The process of allocating asset values to services is inherently complex. The ACCC has been actively involved in this task over many years. It has received expert advice including that from its consultant Analysys and has had the benefit of industry input through industry consultation. Macquarie believes that the ACCC must now draw on this input and apply its expertise to form a definitive view on the allocation of asset values to fixed line services.

*5. Whether there should be different RABs for different fixed line services? Why/why not? If so, which assets should and should not be included in the different RABs for each service? Consider the layered nature of telecommunications service provision in your response.*

Macquarie believes that there should only be one locked-in RAB as described above in its response to question 4. The result of the assignment of asset values from this RAB to specific services could be described as a specific RAB for a specific service or "different RABs for different services". Macquarie takes the view that a service specific RAB should not be considered as a separate RAB but rather a sub-set of a single RAB.

For the avoidance of doubt, Macquarie does not believe that it would be appropriate to have, for example, a locked-in RAB for setting the price of service X and re-valued RAB for setting the price of service Y. Such an approach would seem overly complex for pricing a group of fixed line services which have a relatively high degree of homogeneity.

*6. How should past compensation to the access provider (i.e. past depreciation) be taken into account in setting an opening RAB?*

The approach for addressing how past compensation should be taken into account must be consistent with the asset valuation approach which is used to set an opening RAB. As set out in the Discussion Paper there are alternative approaches for measuring the value of assets.

The asset valuation approach currently used by the ACCC is optimized replacement cost (“**ORC**”). It is recognised that there are significant problems with ORC and that an alternative asset valuation approach is the key subject of the ACCC’s present review. Depreciated optimized replacement cost (“**DORC**”) is widely used in the energy sector. However, it too suffers many problems which are primarily hereditary as result of creating DORC from ORC. Macquarie believes that depreciated historic cost / actual cost (“**DHC**”) by contrast is relatively simple and objective and, as such, should be adopted by the ACCC in its costing methodology to set an opening RAB.

Consistent with the adoption of DHC as the asset valuation approach, past depreciation should be deducted from the gross value (purchase price) of each asset. The amount of past compensation (depreciation) to be taken into account in setting an opening RAB should reflect the actual depreciation that has been allowed to be recovered in access charges. To the extent that the depreciation allowed has been above that recovered in the historical accounts, the asset base should be adjusted downward to reflect the difference. Likewise, if depreciation allowed is below that recovered in the historical accounts, the asset base should be adjusted upward.

*7. Which approach to valuing sunk assets should be used in setting an opening RAB?*

Sunk assets are those assets which have no recoverable value, and which have no opportunity cost. Macquarie’s view is that sunk assets should not be accounted for in an opening RAB. This is because if such assets have no recoverable value or alternative use, they should not be included in the cost base that the access provider seeks to recover. If such assets were included it would be unfair to access seekers. That is, it would be unfair for Telstra to extract from access seekers a return on certain assets if Telstra cannot otherwise earn a return on those assets.

*8. Whether the same approach should be applied to all asset categories, or whether different approaches should be applied to different asset categories (e.g. ducts and pipes versus electronics)?*

As a principle, Macquarie believes that all asset categories should be valued on the same basis. This is consistent with keeping regulatory processes as simple as possible and a recognition of the relatively high degree of homogeneity among fixed line services.

*9. If a DORC valuation were to be adopted, which approach to constructing DORC should be used?*

As noted above in its response to question 6, Macquarie believes that the appropriate RAB valuation approach that the ACCC should adopt is DHC. In Macquarie's view, DORC is the next best alternative approach. The Discussion Paper considers two approaches to the calculation of DORC, i.e., the "depreciation" approach and the NPV cost based approach. Macquarie considers that the former approach, because of its relative simplicity, is preferred should DORC be adopted by the ACCC.

*10. The path of access prices over time that should be adopted — interested parties should consider whether cost-recovery should be front loaded (suggesting that the path of access prices over time will fall), back loaded (suggesting the path of access prices over time will rise) or in equal amounts in each regulatory period.*

Macquarie believes that costs should be recovered in equal amounts over each regulatory period. This removes any bias in the pricing approach and balances the competing interests of the access provider and access seekers.

*11. Which approach to depreciation should subsequently be adopted?*

Depreciation could be front loaded, back loaded or straight line. Macquarie is of the view that the interests of the access provider, access seekers and end users is best served by a smoothed approach to capital recovery such as that via the use of an annuity approach to depreciation. This approach is particularly suitable to those assets whose cost is heavy and life is long. The outcome of this approach is that depreciation is back loaded and prices are reasonably constant.

*12. Whether rate shocks are likely to be a concern in the telecommunications context? If so, what approach should be taken to reducing the size of the rate shock?*

Macquarie does not believe that rate shocks are likely to be of concern in the present context. Such shocks are only likely to occur if Telstra makes a significant investment in its fixed network. Given that Telstra's fixed network is becoming technologically and operationally obsolete - especially in the light of the emerging NBN - Telstra is unlikely to make any major new investment in fixed network infrastructure. Moreover, any investment which is made is unlikely to be significant relative to the existing value of fixed network assets. It follows that the ACCC should not be concerned with addressing rate shock in its fixed line service pricing regime.

*13. Whether the approach to depreciation should be the same for all classes of assets in the RAB? Why/why not?*

Consistent with its response to question 8, Macquarie believes that the approach to depreciation should be the same for all assets.

*14. What is the appropriate period over which to recover these costs - i.e. appropriate asset lives?*

It may be argued that if, as Macquarie believes, Telstra's fixed network is becoming technologically and operationally obsolete, that shorter asset lives for Telstra's fixed network assets should be adopted. However, at this point in time there is much uncertainty about when the NBN will be operational and whether or not Telstra would continue to operate its fixed network. Given this uncertainty, Macquarie believes that current book asset lives should remain unchanged. However, this matter may be revisited at a time when there is more certainty about the NBN.

*15. Whether mechanisms are required in order to encourage access providers to incur costs efficiently?*

As a principle, Macquarie agrees that there should be regulatory mechanisms to encourage access providers to incur costs efficiently. This is necessary to ensure that access seekers are not forced to pay for the access provider's inefficiency. Such an outcome would be unfair to access seekers and would perversely reward the access provider for being inefficient.

Macquarie contends that while Telstra is vertically integrated it will have the incentive and opportunity to incur capital and operational expenditure and to allocate costs in a manner that favours its interests to the detriment of access seekers. Therefore, a structurally (or functionally) separate Telstra would ameliorate concerns about efficient expenditures.

*16. In the context of a pricing approach which locks-in and rolls-forward the RAB, the mechanisms that should be adopted to create incentives to incur efficient capital expenditure?*

Macquarie believes that an *ex ante* prudency check would be appropriate whereby the ACCC would review Telstra's capital expenditure proposals leading into a regulatory period and would make an assessment of whether planned fixed network capital expenditure was reasonable. The approved expenditure would then underlie the incentive mechanism whereby Telstra could keep any savings in expenditure below that forecast. Such a prudency check would be intended to encourage Telstra to avoid "gold-plating" its fixed network investments at the expense of access seekers.

*17. In the context of a pricing approach which locks-in and rolls-forward the RAB, the mechanisms that should be adopted to create incentives to incur efficient operational expenditure?*

Macquarie believes that a prudency check as described in its response to the previous question would also be appropriate in the case of operational expenditure.

*18. Whether if the RAB is locked in or re-valued impacts upon which efficiency mechanisms will encourage efficiencies in capital and operations expenditure?*

A locked-in DHC based RAB as opposed to a re-valued RAB removes the discipline of future network optimization. As such, a locked-in RAB requires the use of a mechanism to encourage efficiency in capital and operations expenditure.

*19. What the appropriate length of time between reviewing regulated prices (i.e. an appropriate length for the regulatory period) is, and why?*

Setting an appropriate length of time between reviewing regulated prices must balance the need for certainty and administrative efficiency with the reality that the telecommunications sector is dynamic. The ACCC's most recent fixed service prices have been set for periods of 19 and 17 months respectively. In order for an access pricing regime to be effective, it should be in place for a period longer than these. Macquarie believes that a five year period best meets the multiple objectives of the regulatory regime including the path of cost recovery, the operation of the incentive mechanism and pricing certainty.

*20. Whether there should be the opportunity for regulated prices to be reviewed in the middle of a regulatory period, in response to particular events? If so, what events should be considered?*

In an ideal situation, regulated prices once set should remain in place for a five year period. This provides the market with certainty. If prices are open to be reviewed during a given regulatory period, such certainty is devalued. As such, Macquarie is of the view that any review should occur only in exceptional circumstances. Such review might be, for example, for the Minister to order if in the ACCC's view a review would be in the public interest or if competition in fixed services was being materially harmed.

*21. Whether the current model non-price terms and conditions and relevant industry codes would provide a sufficient balance for the strength of the incentives created by the mechanism to minimise costs recommended by the interested party in their response to questions 16 and 17?*

Macquarie considers that the current model non-price terms and conditions are comprehensive. Together with relevant industry codes they offer a sound framework for ensuring quality of service. However, it must be appreciated that Telstra has significant market power and is fundamentally a reluctant wholesale service provider. As such, Macquarie believes that a financial performance incentive scheme should be adopted. Such a scheme would be designed to ensure that expenditure efficiency gains do not deteriorate service quality.

Macquarie contends that while Telstra is vertically integrated it will not have the incentive to ensure that the services provided to access seekers are always at the highest possible quality. As such, a structurally (or functionally) separate Telstra would ameliorate concerns about access service quality.

*22. If additional schemes to maintain services standards are recommended, whether a financial incentive scheme or a non-financial incentive scheme should be adopted? What should the schemes look like?*

Macquarie believes that a combination of financial and non-financial incentive schemes should be adopted to ensure that the quality of access services is not compromised. A financial incentive scheme could include penalties in the form of rebates which the access provider would pay to access seekers if service quality falls below agreed standards.

*23. The degree to which the ACCC or the access provider should allocate the costs of service provision to - and therefore set the individual prices of - different fixed line services? Consider the implications of vertical and horizontal structure in your response.*

The Discussion Paper sets out three options for the allocation of costs to services:

- ACCC to undertake this task;
- allocation rules are applied by Telstra (where such rules are either set by the ACCC or the Analysys model is adopted); and
- Telstra has the freedom to undertake this task within a revenue or average price cap.

While Telstra is vertically integrated, Macquarie is strongly opposed to the third of these options. This is because there is a very high risk that Telstra would skew cost allocation to its advantage and therefore to the detriment of its competitors.

Macquarie acknowledges that the cost allocation process is complex and requires considerable resources to administer. At the same time, setting appropriate prices is fundamental to ensuring that competition is effective. On balance, Macquarie favours the continuation of the current process by which the ACCC undertakes the task of cost allocation. This is appropriate on the grounds that:

- the ACCC has built considerable expertise which it can - and should - apply;
- competition in fixed line services is so fragile that the task of fixed service price setting must be closely managed; and
- price setting for fixed line services has been contentious and must be seen to be fair.

*24. If the ACCC continues to allocate costs to individual services, as occurs today, what approach it should use to allocate these costs - for example, the approach adopted in the Analysys cost model, the RAF accounts, etc?*

The allocation of costs to individual services is not only complex but is highly subjective and as such there is little industry consensus. Macquarie's view is that the ACCC has been working in this area for some years now and has developed considerable expertise and has benefitted from a wide range of inputs including industry consultation. On this basis, Macquarie believes that the ACCC is in a position to draw on the various inputs at its disposal (which include the Analysys cost model and the RAF accounts) and make decisions on cost allocation consistent with industry policy objectives.

*25. If the access provider is to be allowed a degree of pricing flexibility, how should this be implemented — should a revenue cap be regulated? Or should a weighted average price cap be regulated?*

Macquarie reiterates its view that while Telstra is vertically integrated, Macquarie is strongly opposed to allowing Telstra to have any degree of cost allocation (and therefore pricing) flexibility. This is because there is a very high risk that Telstra would skew cost allocation to its advantage and to the detriment of its competitors. As such, cost allocation should be a task undertaken by the ACCC.



26. *If regulating weighted average price caps, which services should be included in which baskets? On what basis should the prices be weighted?*

Refer to Macquarie’s response to question 25.

27. *Should the same approach be adopted for all services, or should flexibility be allowed in the pricing of some services but not others?*

Refer to Macquarie’s response to question 25.

28. *Whether access prices should be averaged or de-averaged across regions? For which services?*

Whether access prices should be averaged or de-averaged is a contentious matter. If cost differences for a given service differ significantly between regions, de-averaged prices are generally justified. However, reaching a theoretically pure outcome must be weighed against practicality.

In a previous submission to the ACCC<sup>2</sup>, Macquarie expressed the views that de-averaged prices are for appropriate for the ULLS but not are not appropriate for WLR, PSTN OTA, LCS and LSS. The grounds for these views are summarised in the following table.

**Table 1: Rationale for De-averaged Prices by Access Service**

Access Service	Is De-averaged Pricing Appropriate?	Rationale
ULLS	Yes	Cost structures differ significantly across regions.
WLR	No	Scope of competition is national driven by retail price controls which apply to Telstra.
PSTN OTA, LCS and LSS	No	Cost structures do not differ significantly across regions.

Macquarie reiterates its view that the complexity in the ACCC’s fixed line service pricing regime can be reduced through the structural (or functional) separation of Telstra.

29. *Whether there should be separate RABs for different regions or a single national RAB?*

Consistent with its response to question 28, Macquarie is of the view that in the case of ULLS pricing, the regional cost pools for this service should reflect the annualized cost of those assets which are identified with each region. This will require the breakdown of asset values from a single national RAB into regions through the application of cost allocation rules. Macquarie’s view is that there is a single national RAB and sub-sets of this RAB would be applicable to specific services in different regions.

<sup>2</sup> Macquarie, Submission in Response to Draft Pricing Principles and Indicative Prices for LCS, WLR, PSTN OTA, ULLS, LSS, 9 October 2009, (RG 100902)



*30. If separate RABs for different regions are recommended, on what basis should these separate RABs be defined — e.g. the four band structure used for the ULLS? The Analysys model's Zones A and B? Some other basis?*

Macquarie reiterates that sub-sets of a single national RAB would be applicable to different services in different regions. In addition, Macquarie reiterates its view that a four band pricing structure for the ULLS is appropriate.<sup>3</sup>

*31. Could uniform prices for services for which a uniform price is appropriate be accommodated if regional RABs are adopted?*

Regional RABs or sub-sets of a single national RAB which is applicable to a given service in a given region are only created when pricing for a given service, e.g., ULLS, is de-averaged. As such, there is no conflict between uniform pricing for some services, e.g., WLR and a "regional RAB" used to determine a price for ULLS in "region 1". Macquarie notes, however, if the intention is to develop uniform prices for access services there does not seem to be much utility in establishing regional RABs.

*32. Whether, if there are changes to elements of the current approach to access pricing, access prices should be maintained at their current levels for a period of time, or alternatively, whether the current trend in access prices should be maintained for a period of time?*

Macquarie believes that the continual revaluation of fixed line assets which applies in the ACCC's current price setting approach for fixed line services has resulted in excessive prices, and as such, has constrained competition. A shift to a locked-in DHC based RAB is expected to *ceteris paribus* reduce fixed line service access prices. Macquarie believes that lower access prices should apply immediately so that the benefits can flow through from access seekers to end consumers as soon as possible.

*33. If it is desirable to maintain current prices, or the trend in current access prices for a period of time, what period of time would be appropriate? Interested parties should consider the impact on the legislative criteria.*

Macquarie does not expect that higher access prices will result from the ACCC's review of fixed line pricing. However, should this be the case, it would of course be desirable to delay the detrimental impact that this would have on access seekers, competition and ultimately consumers.

As noted in its response to question 1, Macquarie values price certainty. For this reason, it is appropriate to adopt a locked-in RAB and to minimise price shocks through glide paths where there are significant changes.

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<sup>3</sup> *ibid*

Closing

Macquarie believes that the ACCC's current approach to the pricing of fixed line services is disadvantageous to access seekers and is detrimental to competition. Accordingly, Macquarie welcomes the ACCC's review of the pricing of fixed line services as this review has the prospect of correcting some evident flaws in the existing approach. In addition, Macquarie believes that reforming industry structure through the structural (or functional) separation of Telstra would contribute greatly towards achieving efficient pricing, efficient capital and operational expenditure and ensuring service quality standards are achieved.

Macquarie urges the ACCC to expedite this review. The ACCC should set out its timetable for finalising this review and implementing its outcomes in the very near future.

Macquarie would welcome an opportunity to discuss the detail of this submission with you. Should you have any queries please do not hesitate to contact me.

Yours sincerely



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