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Report

Optus submission on Future Access Pricing approaches for PSTN, ULLS and LCS

1. Overview

1.1 Optus welcomes the ACCC's proactive approach to preparing for the development of model terms and conditions or indicative prices for Telstra's core telecommunications services. Indicative prices are likely to become a valuable tool for resolving access pricing matters. Through this process we expect that the ACCC can provide greater certainty to parties as to the likely outcome of a regulatory determination. In particular, we believe the indicative prices will be readily used by the ACCC to consider access disputes *and* access undertakings.

1.2 Timing is likely to be important when we consider that the Telecommunications Competition Bill 2002 requires the ACCC to publish model terms and conditions within six months of the Bill passing. Notwithstanding this pressure, we believe the indicative prices need to be a comprehensive and independent assessment by the ACCC of appropriate price paths. The ACCC should state that the indicative prices effectively set a natural floor in the prices access seekers can negotiate for the core services. The indicative prices may also practically limit Telstra's capacity to submit access undertakings at rates which exceed the indicative prices – however, given the ability of Telstra to seek merits review of access undertaking determinations we expect this to have a modest impact.

1.3 The consultation process on indicative prices needs to be extensive. Open consultation will greatly increase the reliability and accuracy of the indicative prices. As a result of previous undertakings, arbitrations and appeals on these services, the industry is reasonably well prepared for a robust consultation process and can readily identify the key issues to be resolved. To facilitate the process, there will need to be a high level of disclosure of network architecture, cost and traffic information as well as modelling assumptions. Critically, it must also include access to the economic models (including the Telstra PIE model) and costing methodologies used by the ACCC. Robust confidentiality arrangements have been established for internal and external experts in the past and the ACCC should adopt these previously established arrangements. Without disclosure, the likelihood of on-going disputes on access prices will not be reduced and the likelihood of disquiet in a non-transparent process will be high.

1.4 The ACCC Discussion Paper provides a broad overview of the process for developing indicative prices. Clearly, for PSTN and ULLS, the most important issue addressed is the choice of economic model. This is fundamental to the TSLRIC approach to pricing access and will have a significant impact on the

outcomes of the exercise. Optus has grave concerns that the ACCC is engaging the Telstra PIE model without any form of disclosure about the PIE models (including version 2). We believe if the model is to be adopted, the procedural fairness of the ACCC model terms and conditions will be called into question. Moreover, we are concerned that the PIE model will be grossly inappropriate for the purpose of modelling a forward-looking efficient network. If Telstra, through its PIE is a model is modelling its existing network architecture and existing equipment (without major optimisation of equipment choice and network design), with historic structures, relationships and parameters and which is designed to provide a multitude of services beyond the regulated services, then the PIE model is likely to be highly unsuitable for the ACCC's model terms and conditions.

1.5 Optus believes the first best solution is to design an appropriate forward-looking model based on a scorched earth approach. However, assuming the ACCC continues to prefer a scorched node model rather than a scorched earth model, the second best option is clearly an update of n/e/r/a model. In undertaking an update of n/e/r/a model (or even if a new model is adopted) the ACCC needs to ask itself "what parts of the model need to be updated for optimal forward-looking changes in the network?" Any model should only be updated for "optimal" changes in the network, and even then, only changes that are optimised to provide the regulated service being costed. Optus believes that a *necessary condition* for accepting any changes to the n/e/r/a model or the acceptance of any alternative models (such as PIE 2) is that it must result in more efficient conditions because of increases in productive and technical efficiency since the n/e/r/a model was developed. If the models do not result in a price reduction then the revised or new model should be treated as unreliable.

1.6 Optus believes the current pricing approach for LCS has entrenched a price squeeze in the market for Local Call Resale (LCR). This is because the ACCC uses Telstra's unbundled calling plan price as the starting point for its retail minus avoidable cost methodology. This substantially weakens the ACCC's regulation of Telstra LCS services. Optus strongly supports the use of avoidable cost methodology based on an average of all Telstra's retail local call offerings. This will allow the benefits of competition to flow through to consumers more broadly than is presently the case. It will not, as asserted by some, result in a ratcheting down of access prices.

2. Introduction

2.1 The Government's Telecommunications Competition Bill 2002 includes a requirement for the ACCC to publish non-binding model terms and conditions of access for the core telecommunications services. These core services include originating and terminating access on the Domestic Public Switched Telephone Network (PSTN), the Unconditioned Local Loop Services (ULLS) and the Local Carriage Service (LCS). The ACCC is required to publish these terms and conditions within six months of the Bill being enacted.

2.2 Whilst the term "model terms and conditions" is not specifically defined in the Bill, the Explanatory Memorandum to the Bill indicates that the "aim of releasing model terms and conditions is to assist parties to reach commercial agreement on terms and conditions of access, or to submit access undertakings". Optus interprets these model terms and conditions to encompass both price and non-price terms and conditions to which parties are to agree.

2.3 In this light, Optus believes the ACCC should issue a comprehensive and considered opinion on the future direction of access prices for services provided over the local loop. To ensure this, the assessment should be independent - not merely an adjunct to access undertakings submitted by Telstra. Optus encourages the ACCC to make its processes open, public and transparent. The approach taken in other for a where comprehensive modelling and data information were provided to access seekers is essential. Clearly the timing of developing the benchmarks is also critical – the ACCC has six months in order to publish model terms and conditions. However, it is important that he ACCC's analysis is independent of any undertaking on foot.

2.4 Optus intends to devote significant resources to the consideration of the indicative prices and will provide relevant information to assist the ACCC in establishing indicative rates. It would be very useful if the ACCC could release a timetable for the process, setting out the key milestones for the project and the likely areas for detailed consultation.

3. Role of indicative prices

3.1 Optus believes that the development of indicative prices is very important. The recent Productivity Commission Inquiry and the Government's own investigations have demonstrated some key weaknesses in the current negotiate-arbitrate access pricing model. In particular, negotiating access terms and conditions for "core" telecommunications services that are subject to monopoly supply is beset by:

(a) Information asymmetries;

(b) Lack of transparency; and

(c) Opportunities to game the system.

3.2 As Telstra is the monopoly supplier of "core" telecommunications services, negotiation is problematic. This is in contrast to more competitive services where there is mutual interest in reaching agreement on access prices. Nevertheless, even for core services, negotiation should take primacy when setting access prices and the ACCC should endorse prices agreed on a commercial basis.

3.3 It is widely understood that Part XIC was premised on Telstra being more forthcoming with realistic access undertakings. Instead, the undertakings process has been used, and is likely to be used in the future, as a gaming

mechanism to delay access and extract the highest possible access price, even if it means lodging multiple undertakings for each service, and appealing ACCC determinations to the ACT. In this regard, indicative prices will assist in resolving both access disputes *and* access undertakings. We expect that certainty will be improved, the timeliness of access increased, regulatory costs reduced, and efficiency improved if the indicative prices serve the LTIE.

3.4 Indicative prices will also play an important role in reducing regulatory gaming. If they represent an independent and considered view by the Commission, then access providers will have a transparent benchmark against which to assess the content of any access undertakings. If Telstra lodges an access undertaking while the indicative prices are being developed (as it has indicated it will) it will be important to run the process concurrently but independently. It will also be important to maintain a high degree of transparency to ensure no single party dominates, or exerts undue influence over, the setting of indicative prices.

3.5 Transparency of process is essential to ensure that industry, policy makers and the community can critically review the indicative prices. Information asymmetries need to be broken down. We need an open environment in which Telstra's costs of providing services can be debated to ensure that it receives a price consistent with an efficient forward looking access provider.

3.6 While multilateral agreement on access prices can reduce the regulatory burden, a "one price fits all" approach may not be appropriate. If the economic costs of supplying services to different access seekers varies, than it is efficient for different prices to be paid for access. The ACCC may consider factoring these elements into its model terms and conditions.

4. Duration of indicative prices

4.1 Both access providers and access seekers require some medium term certainty as to the stability and direction of access prices. Commercially negotiated agreements currently tend to last a year to two years. In some cases it can be longer, depending on the requirements of each party. Longer terms offer the considerable benefit of greater certainty.

4.2 In deciding on an appropriate duration for access prices, the ACCC needs to balance the need for certainty, the accuracy of forecasts, potential changes to the optimised network, technology improvements, and investment planning horizons. The goal of setting indicative prices should be to assist commercial negotiations. In this regard, we believe that a forecast of access price should not be less than three years, as a shorter duration would not allow access seekers and access providers to invest with any certainty. More than four years may be too long given forecasting inaccuracies and the speed of technological change. Optus therefore supports a term of three years.

4.3 In the discussion paper, the ACCC has specified possible approaches to indicative pricing. In essence the approaches offered for PSTN, ULLS and LCS would either involve:

(a) Continuous use of an economic model (for PSTN and ULLS) and costing methodology (for LCS) to reset prices over a given period; or

(b) Use of an economic cost model or costing methodology in the first period and setting an "adjustment factor" to estimate future prices.

4.4 It is not clear however how the adjustment factor will be used. Will it be used to forecast for a period of three (or more) years? Alternatively, does the ACCC propose to update its indicative prices annually to reflect actual changes in the parameters included in the adjustment factor?

4.5 In considering the merits of each approach it is important to note that the indicative prices will not actually set the rates charged by Telstra. The actual access prices may be decided by negotiation, arbitration or through an access undertaking. Whilst indicative prices will influence the actual prices charged in each of these cases, their role is simply to guide parties as to the views of the Commission on appropriate terms. In this regard, we believe that an annual update of the economic models and costing approach, or annual revisions of the parameters in the adjustment factor, may create uneconomic incentives to enter short-term arrangements.

4.6 In essence the trade-off is between the benefits of any increased "accuracy" associated with updating the models or the parameters of the adjustment factor, against the costs of revisiting the parameters and approach annually. Optus believes that the benefits are unlikely to outweigh the costs, largely because:

(a) The benefits will be small if the adjustment factor is correctly specified and based on the best forecasts available;

(b) The indicative prices are simply indicative rates; parties can seek a determination from the ACCC if necessary. This may mean that the ACCC duplicates its efforts; and

(c) An annual process may encourage parties to seek wholesale revisions to the methodology annually, increasing the resource cost to the ACCC.

4.7 Optus therefore believes the best approach is to set indicative prices *every 3 years* based on the economic model and costing method established in the first year, and forecasting for 3 years based on the adjustment factor formula. Near the end of that regulatory period, a process can be put in place to update the economic model and costing method where appropriate.

5. PSTN

5.1 Call origination and termination on the PSTN are bottleneck services to which TSLRIC pricing should apply. The prices Telstra charges for call origination and termination are significantly above the costs of an efficient firm would incur, suggesting a high degree of monopoly power in the hands of Telstra. Despite substantial investments by competing carriers, there remains limited

facilities based competition in CBD and Metropolitan areas capable of constraining Telstra.

5.2 The modelling of PSTN costs should be based on the forward-looking costs an efficient firm would incur in providing the service, rather than Telstra's historic costs. The economic model used should capture the costs of call origination and termination of an efficient PSTN network. The bottom-up modelling of PSTN network costs should not capture the historical inefficiencies of the incumbent's network or operations. Proper TSLRIC estimates should not accept the architecture, sizing, technology, linkages or operating decisions of the incumbent as a basis for calculating TSLRIC.

5.3 If the inefficiencies are incorporated they significantly weaken the incentives on Telstra to operate efficiently, they encourage inefficient bypass of bottlenecks, and discourage downstream competition. Critically, it also inflates end-user prices above allocatively efficient levels. It follows that increased inefficiency and discouraging downstream competition is not in the LTIE.

5.4 The ACCC has used a bottom-up TSLRIC model in the past to assess two access undertakings lodged by Telstra: the first in November 1997 and the second in September 1999. The economic model was developed by n/e/r/a on behalf of the ACCC. The ACCC has arbitrated disputes and published indicative prices on the basis of this modelling.

5.5 The n/e/r/a model has deficiencies. It is a scorched node model that was based on parameter values and structural relationships that themselves incorporate many of the inefficiencies in Telstra's networks. The ACCC hs indicated that this represents a compromise to factor in the legitimate business interest of Telstra in setting access prices. There is, however, a spectrum of models that include:

(a) Scorched earth models – These are truly efficient forward-looking models that do not include any inefficiencies of the existing network structure.

(b) Scorched node models – such as n/e/r/a/ model –a compromise that seeks to balance interest of network owner against establishing a forward-looking model by including some of the existing network architecture, but using more efficient parameters (such as number of copper pairs, cost elasticities, etc).

(c) Scorched equipment models – these incorporate all the inefficiencies of the network by re-using existing equipment at existing nodes, with the network simply optimised for existing capacity requirements. They produce costs of the actual network built by the incumbent.

5.6 Optus is concerned that the ACCC dismisses the scorched earth approach in its paper (or the pure forward looking model as described in the ACCC's paper). The ACCC appears to reach this view because it seems to view the build-buy option, which the scorched earth approach most appropriately replicates, as a

theoretical decision, therefore preferring to rely on the access provider's network.

5.7 Access seekers have very real decisions to make about build or buy. Access seekers do not wait for the Commission to make an outcome for the purposes of "sanity checking". Access seekers assess the build-buy option because, as they have done in the past, they are trying to make decisions about investment and, indeed, entry into the market.

5.8 The ACCC is also incorrect in saying that using a forward looking cost model would mean that it would "never make any sense" for an access seeker to build its own network. Again, this view appears to suggest that the ACCC considers the build option to be theoretical. The 'build-buy' decision of new entrants is such that the interconnection charge should be neither too high as to overcompensate the incumbent for sunk capital investment, nor too low as to discourage a new entrant from building out an access network. The ACCC modelling exercise should be *competitively neutral*. Only a truly forward looking access pricing policy gives the correct build-buy signals to entrants. Pricing access above efficient cost would mean that an entrant would prefer to bypass the incumbent's network and construct its own network, even though it would be more efficient to use the incumbent's network.

5.9 It is also incorrect in practice because even if a forward-looking cost model is used there may be many reasons why an access seeker would prefer to build than to buy (eg increasing demand, first mover advantage on a new technology etc). Finally, the ACCC dismisses the pure forward-looking model because it potentially clashes with the legitimate business interests of the access provider. The legitimate business interests of the access provider are not however the baseline position from which the ACCC must work. It is one of the factors to be considered.

5.10 The over-arching object of Part XIC is to promote the LTIE. Optus submits that by allowing access seekers to make a real and practical build-buy decision, the pure forward looking model promotes competition (including facilities based competition) and promotes efficient use and investment in infrastructure. This over-arching factor should not be compromised by inefficient decisions made by access providers and which for-ever influence the price of access in Australia.

5.11 Therefore, Optus maintains its view that the best approach, consistent with the LTIE, is the scorched earth approach. Approaches that rely on scorched node and scorched equipment are inherently inefficient and encourage inefficient utilisation and investment decisions will be made if these models are used.

6. ULLS

6.1 The provision of an efficient ULLS is central to encouraging facilities based competition in telecommunications markets. The ULLS provides the basis for the supply of high-speed data and other broadband services.

6.2 As with the PSTN the appropriate approach for economic regulation is to construct an optimal network that includes all network elements needed to offer the service. Optus broadly supports the ACCC's methodological approach of using TSLRIC for ULLS. However, the ACCC may need to refine this approach to deal with some of the complexity of ULLS pricing and cost allocation, including important cost allocation decisions associated with line sharing.

6.3 The ACCC's report on pricing of ULLS (released in March 2002) uses Telstra's existing IRIM and RSS/RSU nodes as given and optimises other aspects of the network in order to determine the efficient level of ULL costs. This is in contrast to the approach taken in the ACCC's approach to PSTN. In that case the number of IRIM and RSS/RSUs are optimised as per Telstra's efficient forward-looking network.

6.4 We consider that the ACCC's approach to ULLS pricing to be inappropriate. While there may be informational difficulties in optimising the entire network in the case of PSTN, this difficulty does not exist in the case of determining ULLS where only the last leg of the access network is modelled. This is because the appropriate information on network optimisation already exists in the PSTN decision.

6.5 Failing to optimise the end nodes of a network when that information is readily available is inconsistent with appropriate regulatory principles and will lead to over-recovery of ULLS costs by Telstra.

7. LCS

7.1 A commercial access price for LCS is essential to Optus providing a competitive local call resale (LCR) product. Price competition in the local call market is growing, but is largely focussed in areas where Optus has customers directly connected to its HFC network. Outside this area competition is constrained by the high prices for Telstra's LCS. In 2000-01 Telstra retained over 83% of the retail market for local telephony giving it a dominant position in the market and the ability to set prices (subject to compliance with retail price control arrangements).

7.2 The ACCC final report on indicative pricing for LCS (released in April 2002) has established the retail minus avoidable cost methodology. Optus continues to support this methodology, particularly while cost-based models of LCS by Telstra are subject to a lack of transparency and potential gaming.

7.3 However, Optus believes the ACCC has entrenched a price squeeze in its approach to LCR. This is because the ACCC is using Telstra's unbundled calling plan price as the starting point for its retail minus avoidable cost methodology. This substantially weakens the ACCC regulation of Telstra LCS services. For example, Telstra can price unbundled local calls at 22 cents per call, and its bundled offering at 15 cents per call. If the ACCC worked out the

discount off Telstra's 22 cent price, resellers would not be able to compete against Telstra's retail 15 cent calling price for its bundled pricing plans.

7.4 The ACCC's current procedure for calculating avoidable costs provides Telstra with long run incentives to shift its customers (particularly those that are price sensitive) onto non-standard bundled pricing plans, thereby effectively escaping obligations to supply wholesale LCR at avoidable cost based prices.

7.5 Regulators in the US apply the avoidable cost methodology to all standard incumbent retail price offerings, and to non-transitory promotional price offerings that last for a period greater than 90 days. In contrast, the ACCC's current approach, if it only works off the unbundled LCS price, selectively applies the avoidable cost methodology to only the highest of Telstra's standard prices. This issue should be central to the preparation of indicative prices for LCS going forward.

8. Approach to future pricing of PSTN and ULLS

8.1 The modelling of PSTN costs should be based on the forward-looking costs an efficient firm would incur in providing the service. Telstra's historic costs should only be used as a cap on the access charges derived from a TSLRIC model. In no circumstances should Telstra be entitled to recover in excess of its historic costs because this would result in a windfall gain to Telstra and would allow Telstra to cross-subsidise future investment decisions from this windfall. It would not be in the long-term interests of end users to allow this cross-subsidisation of investment to occur.

Choice of economic model

8.2 While considerable work has been undertaken to date, it has been some time since the economic models were reviewed in detail. As the ACCC is essentially starting afresh, Optus believes that the first best is the development of new economic model based on a truly efficient forward-looking network, that is, a scorched earth approach. We recognise however, that the ACCC has taken alternative views on the appropriateness of scorched earth models. We also acknowledge the time and resource constraints associated with developing new model.

8.3 The second best approach is updating the n/e/r/a model. This model is the result of substantial consultation and independent assessment and has been used as a reliable reference point for prices in the past. In contrast, the use of the PIE or PIE 2 models – which were developed by Telstra for its recent ACT appeal - creates untenable issues of procedural fairness that we do not believe any level of transparency would overcome. Our concerns are compounded when it is indicated that the level of transparency would be restricted to "some of the key inputs and parameters of that model". This is clearly insufficient. Optus believes the risk of regulatory capture associated with using the PIE model to be high.

8.4 Moreover, Optus does not believe the ACCC's choice between the PIE models and the n/e/r/a model should be based on whether PIE or PIE 2 "better represents the current network structure and traffic paths than the Commission's n/e/r/a model". Nor do we agree that it is necessarily an "advantage that asset and network architecture changes since the n/e/r/a model was developed would be directly taken into account and would arguably better reflect a practical forward-looking network than n/e/r/a model does now", for the reasons discussed below.

8.5 In considering any update to the n/e/r/a model (or the adoption of the PIE models) the ACCC needs to ask itself, "what parts of the model need to be updated for optimal forward-looking changes in the network?" Any model should only be updated for "optimal" changes in the network, and even then, only changes that are optimised to provide the regulated service being costed at a lower price. Telstra decisions to change the asset and network architecture should be carefully scrutinised before they are factored into the model.

8.6 PIE 2 may well better represent the "current network structure and traffic paths", but these network changes may not be in the long-term interests of the users of PSTN and ULL services. In Optus' view consideration should only be given to network changes such as:

(a) Updated technology for new, lower cost technologies, and delivery methods (eg. Aerial delivery);

(b) Optimal additions to network, but only those that that more efficiently aid the PSTN and ULL service;

(c) Removal of redundancy from the PSTN network; and

(d) Improved cost allocations amongst services that utilise the PSTN (eg. ISDN, line sharing, broadband via xDSL, etc)

8.7 Clearly these types of changes are efficient and specific to the provision of the service being regulated.

8.8 As a result, Optus believe that a *necessary condition* for accepting any changes to the n/e/r/a model or the acceptance of any alternative models (such as PIE 2) is that it must result in a price reduction. If the existing parameters of the n/e/r/a model are factored into the new or updated model, these will necessarily result in efficiencies being passed through to access seekers, thus resulting in a price reduction – simply because the new model assumes efficient changes to the network. This will be an important check on the approach used by the ACCC.

Calculating an adjustment factor

8.9 Optus agrees that an adjustment factor approach is useful in forecasting PSTN and ULLS access prices into the future. If the economic modelling process is robust, it is feasible to set a path of access prices for a number of years. While the accuracy of the prices will be less than a re-casting of the model, it should be sufficient if the adjustment factor is specified to capture the relationship (or

elasticity) between network costs and expected changes in outputs, technologies and other external factors.

8.10 As the purpose of the adjustment factor is to estimate future access prices it is appropriate to use forecasts for changes in the parameters being used. We believe the ACCC has largely correctly identified the parameters that need to be specified and forecast, though consideration could also be given to a productive efficiency improvement factor to include in the overall adjustment factor although Optus recognises that the equi-proportionate mark up approach does factor this in to some extent (if capital costs are also reduced). This would reflect Telstra on-going productive efficiency in operating and maintaining the network.

8.11 CPI is a general measure of prices for consumer goods and services. Its use in this regulatory context is to serve as proxy for changes in the key input costs of operating the PSTN. The CPI may or may not be the most pertinent for telecommunications assets; further consideration of this point is necessary. However, we note one advantage of the CPI is that it is independently published and reflected in financial markets, and is not influenced by the purchasing activities of a telecommunications carrier. In the event that the CPI (which is based on a bundle of goods and services comprising) is not considered to provide a reasonable representation of the key input costs, it may be possible to construct a composite index to reflect likely changes in cost.

8.12 It is entirely appropriate to include a technology efficiency factor in the adjustment mechanism. We note the work undertaken by Gibson Quai for the Australian Communication Authority to establish a TECH factor for various network components and technologies. The TECH factor is based on the expected change in the real asset price of the network component. Similar factors could be generated and weighted to establish an overall network technology factor to adjust network costs.

8.13 Optus believes that a technology factor that incorporates optimal changes in the network profile should not be dismissed out of hand. The results of the n/e/r/a modelling process identify a number of "sensitivities" that could readily be used to construct a technology factor. For example, increased optimal use of aerial network and trench sharing may have a substantial impact on network costs.

8.14 Again, it is appropriate that an output factor be included in the model. However, the ACCC must recognise the potential for Telstra to game output forecasts. This issue can be recognised and minimised by an independent assessment of forecasts. It will also be necessary to carefully implement the unit cost elasticity of output. We note that the elasticity estimate itself will be highly sensitivity to the size of any expect changes in output over the period. For example, an estimated "point" cost elasticity of output may not be appropriate for more than incremental changes in output over the regulatory period. In this case we would need to scale the network model for changes in output up and down.

8.15 The ACCC has proposed a separate adjustment factor for the Access Deficit (AD). This is appropriate given the external nature of the Retail Price Control mechanism. Optus does not, however, agree with the ACCC's proposed "simple straight line adjustment" of the AD itself. Optus believes that it is inappropriate to apply no adjustment factor to the line costs that underlie the AD calculation. Over a three-year period, we expect that efficiencies in the cost of access could be substantial. Without an adjustment factor Telstra will be effectively overcompensated for the cost of operating the CAN. Once this adjustment is made, Optus would not object to a "levelisation" of these efficiencies so that the adjustment factor is spread evenly over the relevant period.

8.16 Optus believes that applying an adjustment factor to line costs is unlikely to be complex, and that it is feasible to apply an adjustment factor to line costs that would be similar in design and operation to the PSTN and ULLS cost adjustment factors. Moreover, even with an inelastic demand for line access, we would be surprised if the administrative costs of applying this factor would outweigh the efficiency losses from overpaying Telstra for operating the CAN.

Model inputs and pricing principles

8.17 Optus will provide much more detailed input concerning individual model parameters at later stages of the consultation processes. However, there a number of broad views on the ADC, cost allocations and the WACC which we will put now.

8.18 Optus welcomes a review of the access deficit and would support a move to a 20:80 rule (with 20% of the access deficit allocated on a per call basis) for access deficit allocation, to bring it in line with Telstra charging structure. Optus submits that the existing 50:50 rule creates opportunities for gaming by Telstra given its call hold times and charging structure.

8.19 As Optus has previously argued, if the access deficit is to be recovered from usage charges, there is no reason related to economic efficiency why flagfall costs should be used to recover it. In the absence of robust information of differences in the elasticity of demand for making calls versus call duration, there is a reasonable economic position that the allocation of an access deficit on long-distance should be done on a directly attributable cost basis. This cost should be allocated in proportion to the directly attributable costs of long-distance call usage versus call set-up.

8.20 Optus also believes that the true "access deficit" is *not* equal to access costs less line rental revenue, but is really equal to access costs less "all contributions to net revenue that flow from the use of the access network in the provision of services". In practice Telstra is gaining a return on the access network through other sources (eg, broadband). This contribution to the recovery of access network costs should also be included in the calculation of the access deficit. Conceivably when this is done, we may find the access deficit is zero or negative. The rents (or super normal profits) from other access services should also be netted out. As competition intensifies these rents will be dissipated and

hence no such netting out would occur. However, in many of these markets, Telstra's has market power and its pricing is not constrained by competition.

8.21 The correct definition of an access deficit is equal to the net revenues from supply of monopoly and quasi monopoly services over the local loop, less the costs of provision of the loop. Under such a definition, the net revenue contributions to fixed loop costs from monopoly services must be taken into account, in determining whether or not there is an access deficit. They include:

(a) ISDN;

(b) Leased Lines;

(c) Data services;

(d) Text Services;

(e) Broad band;

(f) Subscription television;

(g) Directory Services;

(h) Mobile to fixed and fixed to mobiles services

8.22 For example, ISDN traffic passes through the network in the same way as PSTN traffic and uses the same core network components — thus contributing to traffic volumes and reducing unit costs. It should be included, and is done so in most top down and bottom up models used internationally.

8.23 The Weighted Average Cost of Capital (WACC) has a significant impact on the cost of interconnection. Optus supports the use of the CAPM model to determine the WACC, where the WACC is set on a vanilla WACC basis and tax effects are accounted for in the net cash flows of the firm.

9. Approach to future pricing of LCS

9.1 The market for LCS is extremely difficult for Optus. Local Call Resale (LCR) generates substantial losses that cannot be recouped on margins for Long Distance, international and fixed-to-mobile calls. Without reform to LCS pricing we believe that as a standalone business, it will become unsustainable.

9.2 Regulation is failing competition because it gives Telstra the ability to price local calls for some customers at levels close to what it charges for wholesale LCS. The fact that access prices are calculated on the basis of Telstra's unbundled standard call price, rather than the average of its local call prices, combined with its economies of scale, means that Telstra can easily offer consistently lower prices for at least some of its customers than its competitors.

9.3 In addition to creating this price squeeze, the ACCC's current procedure for calculating avoidable costs provides Telstra with a strong incentive to inefficiently price discriminate between Telstra's pre-selected retail customers who take a non-standard bundled product offering, and those customers who use a competing service provider for either pre-selected or local call services. This allows Telstra to effectively escape its obligations to supply LCR at avoidable cost based prices. This is because when calculating the avoidable cost for LCR, the ACCC only takes into account Telstra's unbundled calling plan price.

9.4 This conduct makes it difficult for access seekers to compete in the market for local call services, as well as the markets for pre-selected fixed telephony services. Access seekers need to bundle local and long-distance services in order to compete with Telstra in downstream markets for pre-selected services. It is extremely difficult for Optus to do this, given that Telstra's marginal costs of providing LCS are lower at present than Optus' through economies of scale.

9.5 From a dynamic efficiency perspective, this situation is extremely undesirable. Telstra's conduct, if allowed to continue, will substantially reduce competition in the range of telecommunications markets, including local telephony, long distance, international, fixed to mobile services and importantly broadband services.

9.6 Indeed, AAPT announced[1] that it will no longer offer local call services to new residential customers, suggesting that Telstra's market conduct is having the effect of lessening competition in the market for LCS[2].

9.7 As a regulatory response to these problems, Optus strongly supports the use of avoidable cost methodology based on *an average of all Telstra's offerings*, rather than selectively on Telstra's highest local call price. A precedent for this system has been established in the United States where regulators apply the avoidable cost methodology to all standard incumbent retail price offerings, and to non-transitory promotional price offerings that last for a period greater than 90 days.

9.8 The ACCC, in its report on LCS pricing[3], raised concerns that this approach may have the effect of "ratcheting down" the LCS price. Ratcheting down refers to the situation where access seekers reduce their retail local call prices, then access providers are forced to do the same in order to avoid a loss to market share, thereby reducing the LCS price. This, in turn, may create incentives for a further round of price reductions, and so on.

9.9 On the basis of well-established principles of market interactions (termed by some as *game theory*), Optus believes that ratcheting down will not occur in these markets, and that the market will converge towards a relatively stable

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1 Sydney Morning Herald, "AAPT blames Telstra charges as it quits local call", 30 September 2001.

2 AAPT claim that the wholesale prices charged by Telstra make it uneconomic to resell local call services.

3 ACCC, Local Carriage Services pricing principles and indicative prices, Final Report.

equilibrium under which real competitive gains will be passed on to customers in the form of lower local call prices.

9.10 Equilibrium (a Nash equilibrium) occurs where each market participant's strategy is based on maximising its own profit subject to conjectures about how every other market participant will react to the strategies adopted by all market participants other than itself. Participants will always play the dominant strategy whenever it exists. Ratcheting down LCS is not a dominant strategy and therefore will not occur, even if LCS pricing is based on an average of all Telstra's offerings, rather than selectively on Telstra's highest local call price.

9.11 To illustrate this point, assume that a firm was considering reducing its LCR price in an attempt to gain market share. If its LCS prices were based on an average of Telstra's local call pricing, this may appear to be a dominant and profitable strategy. However, that firm would know that if it were to do so, its competitors would follow suit to avoid losing customers[4]. So long as the competitors moved to meet the price reduction, the firm that initially lowered its prices would fail to gain any market share. Incentives for access seekers to anti-competitively undercut Telstra would be further diminished through their knowledge that Telstra may able to maintain price reductions for longer periods of time due to its ability to reap economies of scale.

9.12 We note that One.Tel, even under the present LCS pricing regime, pursued a short-term strategy of deep discounting on local call services. Retail local call prices were set at levels close to, or below, costs. This was an unsustainable strategy that did not result in long-term market share advantages.

9.13 Of course, if competitors can offer real reductions in local call prices based on lower margins or improved cost efficiency than these will continue to be profitably passed on to customers, and competitors will eat into Telstra's market share.

9.14 Note also that ratcheting down prices in response to competitor pricing behaviour is not likely to be a dominant strategy for Telstra. If Telstra maintains its local call prices the "strategy" of discounting by its competitors (to cause ratcheting down of access prices) will be unprofitable and therefore not dominant. [5]

9.15 Importantly, this argument should not be interpreted such that incentives would be lost to pass on price reductions to reflect efficiency gains. To illustrate, assume a firm made efficiency gains to the point that it was able to offer price reductions that its competitors could not economically sustain. It would clearly be a profitable strategy for the firm to offer the price reduction in response to its ability to do so.

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[4] They could all do this profitably because the access price (LCS price) would fall when Telstra reduced its local call price

[5] These are scenarios that all firms would be able to anticipate, so it is therefore highly unlikely that ratcheting down would ever materialise – at least not on a long-term basis.

Calculating an adjustment factor

9.16 A forecast of LCS prices for a three year period could easily be established by using an appropriately specified adjustment factor. Adjustments should be made to the avoidable costs established in the first year. The costing methodology employed by n/e/r/a is broadly suitable to apply again. Efforts should be made to make the process as transparent as possible to ensure that changes in retail costs and Telstra's RAF allocations are independently review and robust.

9.17 The adjustment factor proposed by the ACCC appears to be appropriate. It captures movements in the general level of costs (the proxy being the CPI) and it passes on the productivity and efficiency gains made by Telstra. Optus hopes that there will be further opportunities to consult on the construction or benchmarking of any Total Factor Productivity (TFP) indices.