Submission to the ACCC on ULLS regulation

This submission to the ACCC represents the private views of group supporting Telecommunications Deregulation.

ULLS should not be price regulated by the ACCC
ULLS should not be price regulated by the ACCC because Telstra has no market power.

Voice telephony is competitively constrained by mobiles
Mobile telephony constrains the exercise of market power in fixed line voice telephony. Hutchison's latest 3G offer includes $120 worth of calls, and $70 of on-Net calls all for $30 per month. The offer is highly competitive with fixed line telephony, where average expenditure is $65 per month per SIO (service in operation).

Under the capped mobile plans, marginal cost (MC) of usage is zero, so there will be high substitution between fixed and mobile telephony for marginal calls. Most people on capped plans do not exceed their mobile caps, so effective MC is zero.

Fixed lines in operation and minutes of usage are decreasing, whereas mobile services and telephony minutes are increasing. So there is high substitution between the services.

Broadband is competitive or under-developed
Wireless constrains the exercise of market power in low speed broadband (at or below 1.5 megabits per second). And the Optus cable network is a further competitive substitute for broadband in Sydney, Melbourne and Brisbane. 3G Mobiles supplies broadband of 1.5 mbs or more. So there are two direct fixed-line facilities-based competitors in broadband to Telstra and 3 other mobile networks. So ULLS should not be price regulated in capital cities because of effective competition.

High speed broadband should not be price regulated because it a new service where demand characteristics are not well known. The ACCC's Access Pricing Principles 1997 specifically state TSLRIC type pricing methodologies should not be used for new services (see pg 13).

Telstra has no market power
Telstra's current market cap is below the forward-looking replacement costs of its assets. Its returns are significantly below normal market levels. Since listing it has earned less than 50% of the returns provided by the market. So it has no market power in way economists think about the issue— in the sense that Telstra does not and cannot earn supra-normal returns, because the markets it operates in are highly competitive and subject to high technology change. So there is no justification for price regulation.

Price regulation in telecommunications lowers investment and technological innovation. It harms consumers.

Why prices for ULLS should be geographically averaged if it is regulated

Prices for ULLS should not be regulated at all as I discuss in Appendix 1. However, given the ACCC does propose to price regulate, the prices should be geographically averaged.

The ACCC's draft approach to ULLS regulation, with de-averaged prices, is not a desirable economic approach.

Under the ACCC's current approach it regulates Local telephony Services using a retail minus approach and long-distance services using TSLRIC. The approach, in practice, **is** geographically averaged because the local call resale prices are geographically averaged, which comprise about 70% of the total charges. Competitors pay Telstra about $35-$40 per month for local access and $10-$15 per month for long-distance, or total prices of about $50 per month.

Under ULLS, competitors' costs are marginally higher, but competitors only pay about $20 per month in input costs to Telstra (if the ACCC sets the final ULLS price at say $20). And the ACCC is currently proposing geographically de-averaged prices for ULLS, which is inconsistent with its approach to local call resale and long-distance TSLRIC charging.

So a large arbitrage opportunity is created for competitors by using ULLS for voice telephony rather than local call resale and long distance TSLRIC inputs. Competitors save about $30 per month in input costs by using the regulatory arbitrage caused by "cost-based" ULLS.[1]

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[1] It can be fairly easily shown the ACCC's current approach, using de-averaging for ULLS regulation, where Telstra has a geographic averaging constraint, is economically incorrect.

Suppose average costs across a network are $40 per customer, with costs in metro areas at $20 per customer, and $140 per month in regional areas. Suppose downstream+retail costs to services all customers are $10 per month for Telstra. Telstra must therefore charge $50 per month to each customer to achieve cost recovery. Suppose the ACCC sets the access price at $20 in metro areas, consistent with geographically de-averaged network costs.. Any competitor can come in and beat Telstra provided its own downstream costs are less than $30 per month.

 Suppose a competitor has a $15 downstream cost (i.e. $5 more than Telstra). It can then set the retail prices in metro areas at $35 and beat Telstra. Telstra cannot respond by cutting its own price to $35, because then it is required to also drop regional prices to $35 because of the averaging constraint. It will therefore not achieve cost recovery across its network, losing $15 per customer if it "matches" the inefficient competition. So all the ACCC policy does is encourage inefficient downstream firms to cherry-pick Telstra's customers, and set low prices for telephony in city areas which Telstra cannot respond to. Call this error a Type 1 loss.

Suppose instead the ACCC sets geographically averaged prices at $40 per month. Inefficient downstream entry and cherry-picking is then prevented. The danger is someone with network costs of say $25 per month in metro areas will "inefficiently" duplicate Telstra's network. Call this error a Type 2 loss.

Economics says, in the presence of a constraint preventing first best policy, setting a policy at either extreme (perfectly averaged or de-averaged prices) will be bad response. The welfare loss varies with square of the distortion – so inefficient cherry picking is maximised with perfectly de-averaged prices, and inefficient investment is maximised with perfectly averaged prices. A price between the two extremes will cause a lower total welfare loss.

Prices should be set closer to perfectly averaged prices if the possibility of Type 2 losses is small.
Prices should be set closer to de-averaged prices if the possibility of Type 1 losses is small.
It becomes an empirical question whether the welfare losses from inefficient cherry picking are larger than from inefficient investment.

Pricing of ULLS should be based on genuine forward looking economic costs

If the ACCC is to regulate ULLS is should use genuine forwarding looking cost inputs based on present day prices. The TSLRIC of ULLS will have risen substantially over the last two years because of significant rises in the cost of copper and the cost of trenching.

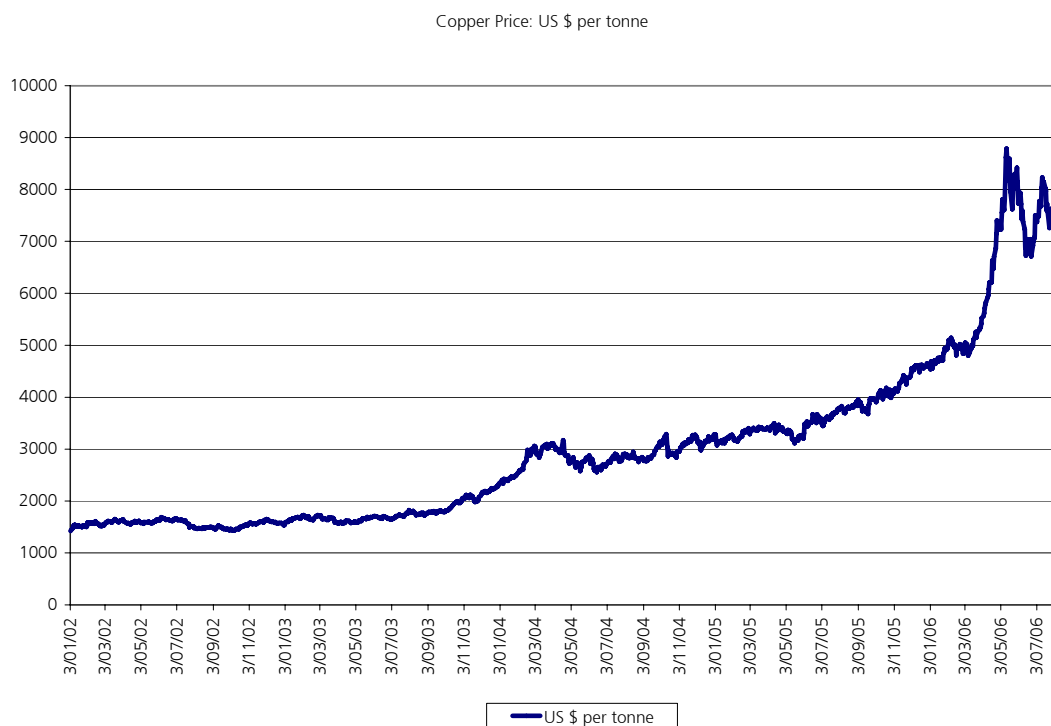**Figure 1: The rise in the cost of copper**

Copper Price: US $ per tonne

Figure 1 shows the daily price of copper in US $ per tonne on the London Metals Exchange since 2002. It has risen from $1500 to $2000 per tonne over the 2002-2003 period to about $7500 per tonne at present.

Type 1 errors are bigger than Type 2 errors so prices for ULLS should be averaged
Now, in practice, there has been virtually no investment in wire-based networks in metropolitan areas in Australia since 1997, even though ULLS has not been available at ACCC estimated "cost based" prices. So the actual practical chances of "inefficient" investment are virtually zero, even though it remains a nice theoretical talking point. The present practical experience in fact seems to be negative facilities-based competition because of the ACCC setting access prices below cost for ULLS. Indeed the ACCC's own access pricing principles are encouraging Optus to turn off its sunk network and instead rely on the "cheaper" resale of Telstra's network. Optus' local telephony and Pay TV customers have been falling since 2003, and it is pro-actively lobbying the ACCC for tougher resale regulation.

Therefore, the ACCC should set prices at or very near geographically averaged prices for ULLS – to minimise the Type 1 losses from inefficient cherry picking. Type 2 losses have previously not occurred over the 1997-2005 period without cost based ULLS. Indeed, the opposite is occurring with de-commissioning of sunk network investments. So the ACCC, based on empirical evidence, should place a low weight on the possibility of Type 2 losses when setting ULLS access prices.

How the copper price affects ULLS

In March 2002 the ACCC set the price of ULLS at about $35 per month in the Band 2 area. Presumably this was based on then prevailing copper price of US $1600 per tonne. The ACCC estimates approximately 24% of the cost of the ULLS is the copper pairs, from home to exchange (See the ACCC NERA model and NERA report). So the ACCC prices set in 2002 implies a price for the copper of $8.40 per SIO.

Now the copper price has risen to $7500 per tonne. Which implies the price of the copper pair alone should be about $39 per line today. The ACCC's 2004-2006 ULLS decisions suggest it wants to set a price of $20 or lower for the entire ULLS to promote competitors. At such a price it means the ACCC is effectively costing the trenching and other network elements at negative value (about -$19 per SIO) according to my calculations.

Trenching costs have also risen
Trenching costs have also increased over the last few years because of the commodities boom.

Reasonable estimates indicate, due to the higher costs of materials, and greater scarcity of labour, that trenching costs would probably be about 30% higher today than in 2002. For example, see AGL's revised cost estimates for constructing the PNG pipeline in July 2006 verses its cost estimates in 2004.[2]

Trenching is 51% of the costs of ULLS. It implies, that trenching today, alone would cost about $23 per SIO, given a $17 per SIO cost of trenching in 2002.

So adjusting two parameters to present day costs, trenching and copper, means the cost of the local loop should be $62 per SIO (for just the trenching and copper part).

So the ACCC, by setting prices at $20 per SIO, seems to be suggesting the other parts of the ULLS (the pillars, IRIM, MUXs and other non-traffic sensitive parts of the switch) contribute -$42 per month to the cost of ULLS. It does not make any sense.

In summary, the ACCC should adjust its cost model to reflect the forwarding looking costs of providing trenching and copper.

The current trajectory of ACCC ULLS prices, going downwards, when the raw material costs of constructing the ULLS have substantially risen over the last few years, makes no economic sense.

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[2] The proposed PNG pipeline will run from the PNG gasfield through North Queensland to central Australia. In 2004-05 AGL provided cost estimates of $2.5 to $3b for building the pipeline. In June 2006 AGL revised upwards the estimate to $4 b because of the rising costs of constructing trenches and materials, and increased scarcity and rising costs of labour. The pipeline will be unregulated. So AGL has no incentives to not state the true estimated costs of construction of the pipeline.

Is the ACCC using TSLRIC?
The ACCC in March 2002 set the price of ULLS at $35 per month per SIO. That was presumable based on a specific price for trenching per meter and copper per SIO. The ACCC would need to know these input values at a minimum to set ULLS prices, because such costs comprise 75% of the costs of ULLS.

In its final decision in 2006 on ULLS pricing the ACCC should explicitly state what costs of trenching per meter and copper per SIO it used in 2002. It should also state the changes in the prices of trenching and copper over the 2002 to 2006 period. It should then state what price of trenching per meter and copper it is now using, and reconciles these input prices with its proposed 2006 prices for ULLS.

Stakeholders in the industry require this minimum level of transparency of cost inputs. Such disclosure is also necessary to insure the ACCC is not merely setting arbitrary prices without an economic basis.

ACCC 2006 ULLS prices cannot be reconciled with forward-looking economic costs
It is difficult to reconcile rising input costs for trenching and copper with the lower ULLS prices the ACCC has proposed over the 2002-2006 period. The ACCC in its Draft 2006 ULLS decision, and 2005 decisions, seems to be suggesting ULLS prices should be $13 to $20 per SIO per month in Band 2.

A possible explanation of the ACCC behaviour in sequentially lowering ULLS prices, when raw material input costs are rising, is that the ACCC is not using a forwarding-looking cost model for ULLS. Rather, it is lowering ULLS prices because it can, and it is the "trendy" thing to do; i.e. it is using a non-scientific approach to promote resale-based competitors.

If the ACCC is merely setting arbitrary and sequentially lower ULLS prices to promote competitors then it should explicitly state that this is its paradigm, and it no longer uses a TSLRIC based model or present day cost inputs.

If the ACCC is using a TSLRIC model, then it should transparently provide the cost inputs it is using for trenching and copper to support that model.

ULLS prices should be consistent with current Local Resale prices
In providing local telephony services competitors of Telstra can either use Local Resale or ULLS. Under Local Resale competitors buy line rental and local calls off Telstra at Retail Minus, and also originating and terminating access for long-distance calls at about 1 cent per minute. They pay Telstra about $50 per month in interconnection costs under Local Resale (see Footnote 1).

Under ULLS competitors would pay Telstra about $20 per month to supply local telephony — if the ACCC sets the ULLS price at $20. Now competitors and Telstra costs under Local Resale and ULLS are about the same, because 90% of the costs of telecommunications is the local loop.

So the current ACCC approach is highly inefficient, because it diverts competitors from Local Resale to ULLS because they save $30 per month in interconnection costs. It is a pure regulatory-established arbitrage, one form of resale has lower prices than another, without any economic cost justification — competitors pay $30 per month less to Telstra using ULLS verses Local Resale.

The ACCC should set the price for ULLS consistent with the current price for Local Resale. So the price for ULLS should equal current interconnect costs per SIO, say $50 per month per SIO, less the costs Telstra avoids from not providing local switching and local to local transmission for local calls — the only costs Telstra avoids from providing ULLS rather than Local Resale. Now the costs of local switching and local transmission would be no more than $5 per month per SIO, so the price competitors should pay for ULLS should be about $45 per month — to be consistent with current Local Resale prices.

Appendix 1: 'Top 7 Myths of the Telco World',

TELSTRA bashing is always popular, but behind the media headlines, very little serious scrutiny is applied to the underlying problem facing the industry - that is, a lack of investment and low returns.

Here's my take on a few other recent myths accepted by some in the media:

1. **If Telstra doesn't build a high speed network, someone else will**
   If Telstra doesn't role out a Fibre to the Node (FTTN) network in capital cities, quite simply, there is unlikely to be one. The '"Gang of Nine" or whatever they call themselves say they can roll-out a network without Telstra. It is unlikely they will. Most of the costs of the network are the last mile of wire based connection from home to node. We already have 3 fixed networks doing it: Telstra copper, and Telstra and Optus HFC. There is unlikely to be a fourth.

2. **Regulation is not stopping Telstra investing**
   The major benefit of FTTN is it provides high speed broadband. Now if the government allows the ACCC to regulate it using its "cost based" approach, then all Telstra need do is roll-out an HFC/wireless solution instead, which escapes regulation. Such an outcome provides another great example of the economic distortions caused by unnecessary regulation in the Australian market.

3. **Sol is to blame for the share price fall**
   I'm always puzzled with Journalists who blame Sol for the share price falling from $5 to $3.70. He has not done anything to decrease the future free cash flows of the company. Analysts value stocks on the basis of the expected future free cash flow, and the share price reflects these analysts' valuations.

   Now all Sol has done is point out more explicitly the cost of regulation. To the extent the share price goes down reflecting the cost of regulation, it is not Sol's fault. All he is doing is getting more accurate information into the market. Which is the right thing to do, and also his duty as the CEO.

   Yet he is being pilloried by the press for telling the truth about how regulation reduces the company's future revenues and free cash flow, when all he is doing is telling the truth!

4. **Regulation is not to blame for Telstra's low share price**
   It is regulation that is driving down the Telstra share price. The ACCC has considered setting the prices of Unbundled Local Loop (ULL) at $13 to $20 per month for 7.5 million of Telstra's 10 million lines. At present these lines have about $65 per month of voice revenue, and say $10 to $20 of potential pay TV or internet revenue going over them. Now it doesn't cost $13 per month to roll out a local loop. If it did, you'd see four or five networks all competing for an $80 plus revenue stream.

   The ACCC's own modelling in 2002 says it costs $35 per month to supply ULL. And if proper adjustments are done for the higher costs now of trenching and copper, compared to 2002, the cost of ULL would be $60 per month. or more now.

   So why does the ACCC set $13 to $20 prices for ULL? Because it is the trendy thing to do . It uses a paradigm of promoting resale-based competitors who essentially need lower and lower access prices to compete against Telstra, because Telstra has much greater downstream economies of scale and scope. So the ACCC is forced into a game, where it promotes inefficient downstream competitors by setting low access prices. Telstra responds by reducing retail prices. Competitors complain. So the ACCC then sets lower access prices. Competitors say they need access at a $13 price or they can't compete, so the ACCC sets the price there.

   That is about the extent of the "science" in the ACCC 's approach.

   The ACCC hasn't genuinely attempted to cost Telstra's ULL network. And it hasn't asked the simple questions: why, if ULL costs $13 or $20, or whatever, don't we see four or five networks? And why don't we see Telstra earning about $9 billion a year in profits? - That would be the result you would get if ULL genuinely cost $13 to $22 per month, given this network supplies over $12 billion of Telstra revenue.

5. **Continuing heavy regulation of Telstra encourages genuine competition and investment**
SingTel Optus owns a high speed broadband network, in which it has invested over $2 billion of capital to reach about 2.2 million homes. Yet at the same time it is arguing for low ULL prices, which completely undermines the economics of its own sunk HFC network. The only reason it is doing it, is because the ACCC prices for the alternative copper ULL are below the operation & maintenance costs of Optus' HFC network . That's right. The ACCC prices not only fail to allow for recovery of sunk capital costs, but must also be set at less than the "continuing costs" for Optus of running its own network, for Optus to be arguing for lower ULL.

So Optus is turning off its network. I understand Optus direct connect telephony customer numbers have fallen from about 510,000 in 2003, to below 490,000 now. And direct connect pay TV has decreased from 250,000 subscribers to below 170,000.

Optus is turning off its network because the ACCC regulations undermine the economics of facilties -based investment and competition. I know of no other country in the world where the local cable competitor is arguing for "tougher" ULL regulation of the incumbent telco operator.

6. **Telstra can afford to take a hit - it's still the most profitable telco in the world**
When Telstra says it earns margins of 52 percent, the statistic is the earnings before interest, tax and depreciation (EBITDA), divided by revenue. But it is a meaningless figure because it does not capture the cost of replacing the network today, or the return on capital or the return of capital.

To explain. Suppose you bought a house 30 years ago for $50,000. Lets say you depreciated it over 60 years, so in the accounting books its written down value is $25,000.

And lets suppose today, to buy the same house, it costs $2 million.

Now suppose you rent out this house for $1000 per week. You are earning a return on your "depreciated" historic cost of investment of 200% pa $50,000/$25,000.

But, on the actual cost of the investment today of $2 million, you are only earning 5% pa. $50,000/ $2 million.

Now, do you think your return of 200 percent is obscene ? Should you be forced by the Government to say only earn a 10% return, and rent your $2 million house out for $50 per week. This is the bankrupt argument some are running against Telstra.

7. **Competition is not effective in constraining Telstra making monopoly profits**
Competition in telecommunications is vigorous and has eroded returns on capital intensive networks, both fixed and mobile. For example, capped mobile plans and VOIP technologies are causing substitution away from Telstra's "core monopoly" product: fixed line telephony. Telstra's fixed lines in operation have been falling by about three percent per capita each year since 2004, and its fixed line revenues have fallen by four percent.

So, even though fixed line prices are falling fast and the regulator has mandated access to Telstra's fixed network at prices below cost, mobile revenues and services are growing, whilst Telstra's fixed line services and profits are contracting - because the four mobile networks are a more than effective competitor to Telstra.

The current returns in Telcos are below normal commercial levels. Since listing in 1997, the return on Telstra's shares, including dividends, has been 80%, or about 8% per annum. The returns for smaller telcos, in general, have been worse. By contrast, the stockmarket over this period has returned 180%, or 15% pa. So an investment in Telstra has yielded less than half the return you would have got from investing in other stocks on the market.

If Telstra was making monopoly profits we would expect it to show up in market out-performance and a high market value attributed to the company.

Back in 1997 Telstra was valued at about $39 billion . Then, the ANZ bank was valued at $17billion, CBA at $22 billion and NAB at $32 billion. Telstra was then worth more than all of our banks, and about the same as CBA and ANZ combined. The ACCC took over regulating Telstra in 1997.

Now Telstra is valued $44 billion, the ANZ bank is worth $49 billion , and CBA and NAB about $58 billion. So the banks values have more than doubled over this time, whilst Telstra's value has remained stagnant. Telstra is now worth less than the third largest bank in Australia, when previously it was worth more than third and second combined .

Who contributes more to our society: the major provider of telephony, mobiles, internet, and pay TV services in Australia or one of the big banks? What would be more costly for Australia, if Telstra and its vast array of communications networks disappeared, or one of the top banks. And whose investment would it be more costly to replace? Telstra's vast national fixed and mobile networks or a bank network ?

So why is the stockmarket putting a higher value on banks than Telstra? Because the regulator is setting the price for access to Telstra's network below cost, and because competition in telecommunications is very vigorous. So the market sets the value of Telstra below the replacement cost of its assets because of regulation. By contrast, the regulator has a much more limited role with banks and is not allowed to set prices in this sector.

The ACCC may say Telstra is earning higher than normal returns, because it wants to justify its current role and keep its job. But, in truth the regulator has no evidence to support the contention. The objective evidence says the exact opposite.

High technology change in telecommunications means there is no need for ACCC access price regulation of Telstra. Such regulation lowers returns even further below normal commercial levels, causes less investment, and harms consumers. Competition is more than effective in constraining returns in the telco industry.

And the ACCC is denying consumers valuable services, such as high speed internet access, because of over-regulation.

The solution?

If the commentators are right, and the 'Gang of Seven' can roll-out an FTTN without Telstra, with a bit of Government funding, say $3 billion, then why are we bothering to regulate Telstra's network at all? It would seem quite easy to bypass Telstra altogether, with a simple one-off Government payment of say $3 billion to a new consortium.

We could then get rid of the Telco specific provisions of the Trade Practices Act, and abolish the multitude of redundant regulators employed in the ACCC 's Telco branch.

The crucial issues facing the telecommunications industry are low investment and low returns.

This is directly attributable to poor regulation which allows the ACCC to over-regulate where competition is effective and not needed, and to set network access prices below cost - because it is the "popular" thing to do.

Significant reforms are needed to create the right climate for investment in telecommunications that will benefit Australian consumers.

The ACCC needs to "declare victory" and get out of Telco specific regulation. Failing that, the government should repeal the ACCC powers to price regulate Telcos.

Appendix 2

ULLS: why its financially onerous for Telstra and reduces investment
The Unbundled local loop service (ULLS) allows competitors to interconnect with
Telstra's network to supply customers with a range of services, including:
- High speed internet access
- Voice telephony (local and long distance calling)
- VOIP (Voice over internet protocol).

ULLS is a declared service, meaning Telstra has to supply it to competitors. The
ACCC sets the price of renting the ULL in the event of an access dispute.

Competitors use ULLS by inserting DSLAMs into Telstra local exchanges, and then
plugging the customer's copper pair into the DSLAM. Telstra has about 550 local
exchanges where ULLS can be accessed. In the five capital cities where ULLS will be
first rolled out Telstra has 250 local exchanges. The largest exchange can give
competitors access to about 120,000 lines.

Pricing of ULLS
Telstra proposed charges for ULLS in December 2004 are set out in Table 1. The charges are consistent with current commercial prices in the market place. The key charge is $22 per month to rent loops in metropolitan city areas (Band 2) shown in bold italics in Table 2.

Band 2 has 7.5 m or 75% of the 10 m services in operation in total. Telstra estimates the lines in Band 2 will be the main ones targeted by competitors to "cherry pick".

Table 2. History of ULLS prices

Telstra proposal December 2004				
Band 1 (CBD)	*Band 2 (City)*	Band 3 (rural)	Band 4 (remote)	Average
$13	*$22*	$40	$100	$30
ACCC recommendation August 2005				
Band 1 (CBD)	*Band 2 (City)*	Band 3 (rural)	Band 4 (remote)	Average
$7	*$13*	$27	$144	$22
Telstra proposal January 2006				
Band 1 (CBD)	*Band 2 (City)*	Band 3 (rural)	Band 4 (remote)	Average
$30	*$30*	$30	$30	$30

ACCC finding
In August 2005 the ACCC rejected Telstra charges as too high, and proposed alternative charges, also shown in Table 1. The $7 charge in the CBD area and the $13 charge in metro areas were 40%-50% below Telstra's proposed charges.[3]

Telstra has rejected the ACCC finding. In January 2006 Telstra re-submitted a new Undertaking with a new average price across all 4 bands of $30 per month per line, as shown in Table 1.

The re-submitted prices were in line with a new campaign by Telstra for both higher, and more averaged ULLS prices across the country. Telstra also sought government intervention to protect it against ULLS regulation, which we discuss below.

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[3] The ACCC also proposed recovery of ULLS specific costs, but did not say how much per line these would be, but suggested the amount would be small, i.e. less than $1 per month per line.

ACCC consideration of new $30 per month ULLS
The ACCC is now considering Telstra's new undertaking with average prices across the 4 bands of $30 per month against a new government directive. The government directive requires the ACCC to consider whether its de-averaged approach is consistent with an obligation on Telstra to maintain retail price parity between city and rural areas.

The government formally mandated Telstra charge city and rural consumers equivalent prices for telephone service in December 2005.

ULLS threatens Telstra's viability
ULLS threatens the profitability of the entire Telstra network. Telstra at present has about 10 million copper lines, from which it earns $7.7 b pa in revenues from voice telephony, or about $65 per month per line. It also earns $3 b pa of internet and data revenues from these lines. So, all up, 50% of Telstra's revenues are under threat from ULLS.

Under ULLS, Telstra is required to rent these lines to competitors in city areas for prices between $7 and $22 per month.

The "cherry picking" opportunity is illustrated in the following Telstra slide.

Figure 2: Competitors will "cherry pick" Telstra's network under ULLS
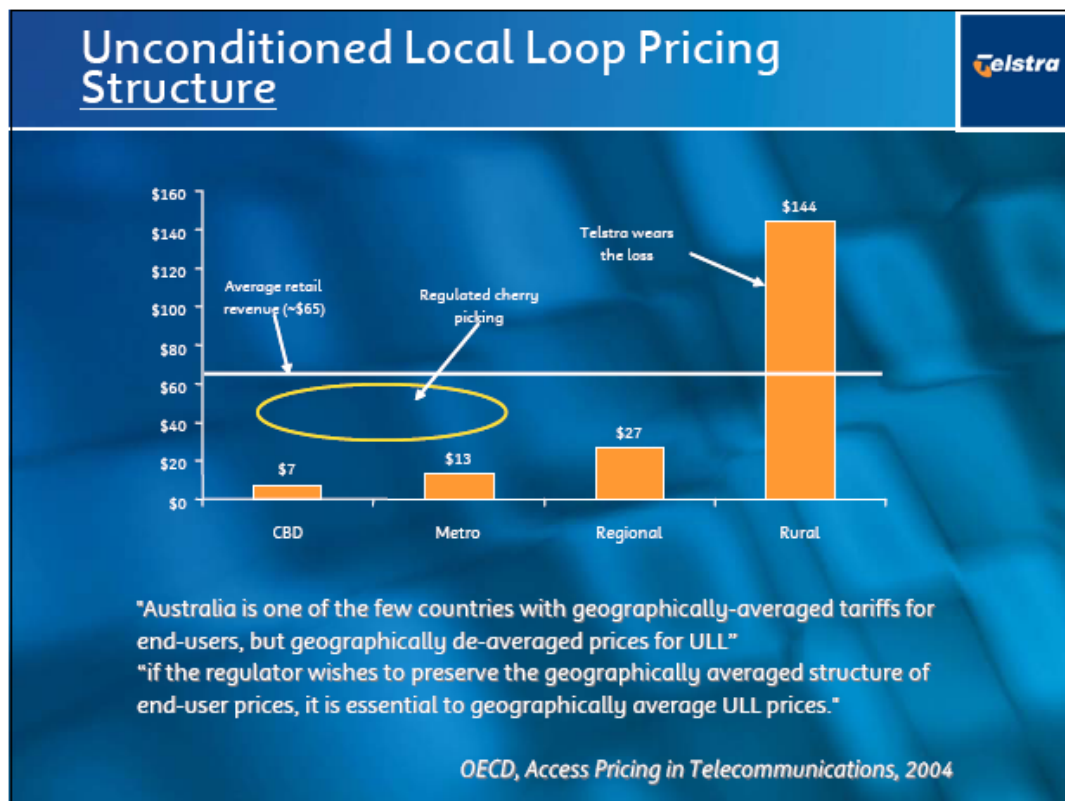
Loss from ULLS
When a competitor takes a ULLS, Telstra on average loses revenue of $65 per month from supplying retail voice telephony services. In return it only receives in wholesale revenue under $25 per month from renting the loops to a competitor. Because competitors can rent Telstra's network cheaply, retail prices for voice services will also collapse. Telstra will then be required to respond to the competition's lower prices for voice telephony or lose more lines to ULLS.

Telstra has a geographic averaging constraint. So any price falls in city areas must also be passed through to its rural customers.

So de-averaged ULLS prices encourage a regulated arbitrage, where inefficient competitors cherry pick the low cost customers. Competitors are also encouraged to "cream-skim" customers, targeting only the high revenue/low cost telephone lines in CBD and metropolitan areas.

Estimates of the loss from ULLS
Under an absolute worst-case outcome Telstra could be forced to rent 7.5 million CBD and metropolitan lines to competitors for about $20 per month. It would gain about $1.8 b pa in wholesale revenue = $20 per month by 12 months by 7.5 million line. But it would retail voice telephony revenue of $5.8 b pa = $65 per month by 12 months by 7.5 million lines. So, in total, it would lose $4 billion of revenue, and incur about the same costs.

So Telstra's current $3.5 billion of net profit pa would turn into a loss under intense ULLS competition. Telstra has consistently complained to the government about the outcome of ULLS regulation.

Telstra estimates of the loss from ULLS
Figure 3: Telstra estimate of the loss from ULLS

Economic Impacts of Regulation: ULL Example

Revenue (cash) Impacts:

⇨ The table below quantifies the 1st and 2nd order impacts of ULL

Band 2 ULL Average Price Assumptions	FY 07/08			FY 09/10			10yr DCF
	$30 $m	$13 $m	Delta $m	$30 $m	$13 $m	Delta $m	
1st Order							
Decline in Wholesale PSTN/BB Resale Revenue	-707	-707	-	-1,068	-1,068	-	
Increase from ULL Revenue Stream	405	190	-215	604	292	-312	} $6.1b
Reduction in Retail Pricing - PSTN & Broadband	-505	-864	-359	-698	-1,167	-469	
Total 1st Order Impact	-807	-1,381	-574	-1,162	-1,943	-781	
2nd Order							
Reduction in Mobile pricing	-	-171	-171	-	-240	-240	} $1.7b

Assumptions:

⇨ Competitor build within Band 2 only and ULL penetration rate @ 20% over 10 years

⇨ 50% of the lower competitor access price are assumed to flow through to retail pricing and is assumed to impact over a 5yr period

⇨ Mobile ARPU reduces to retain fixed/mobile price parity (assumed @ approx 2.0 times)

⇨ DCF calculations are post tax and based on terminal growth rate of 1.5%.

⇨ ULL penetration the same at both $30 and $13 given size of margin opportunity (conservative assumption)

$30 ULLS prices: Telstra loses $1.2 b revenue and $1 b of profit
Under $30 per month ULLS prices, Telstra's loses $1.16 m pa of fixed line revenue and about $970 m pa of profits.

Telstra makes the assumption competitors can cut retail prices to consumers by $25 per month under a $30 ULLS price, and Telstra would have to respond by cutting its own prices by $12.50 per month.

So Telstra loses $12.50 per month by 7.6 m lines = $1.16 m pa.

$13 ULLS prices: Telstra loses $1.9 b revenue and $1.6 b of profit
Under $13 per month ULLS prices, Telstra's loses $1.9 m pa of fixed line revenue and about $1.6 m pa or 34% of profits.

Telstra makes the assumption competitors can cut retail prices to consumers by $42 per month under a $13 ULLS price, and Telstra would have to respond by cutting its own prices by $21 per month.

So Telstra loses $21 per month by 7.6 m lines = $1.9 m pa.