



Optus Submission

in response to the ACCC's discussion paper

Public Inquiry to make Final Access Determinations for the  
Declared Fixed Line Services

June 2011

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## Section 1. Executive Summary

- 1.1 Optus welcomes the opportunity to participate in the Australian Competition and Consumer Commission (ACCC)'s consultation on its proposed final access determinations (FADs) for the declared fixed line services.
- 1.2 There are a number of points Optus endorses in the ACCC's proposed draft determination.
  - (a) First, Optus supports the proposed transition to a pricing approach for fixed line services based on a 'building block' model in which a regulatory asset base (RAB) is 'rolled forward' year on year. The ACCC's approach is a significant improvement on its longstanding 'TSLRIC' methodology since it is more transparent, well documented and will promote price certainty by removing the scope for constant revaluation of the Telstra asset base.
  - (b) Second, Optus strongly endorses the ACCC's proposed move to a single national price for PSTN originating and terminating access. This is consistent with its approach to all other regulated services and is in line with standard practice in retail pricing. This will address significant flaws with the existing rate table, which is archaic, complex and has resulted in significant cost over recovery by Telstra. The proposed uniform pricing approach will ensure cost recovery for Telstra, is simple to administer and apply, will create no distortionary competitive effects and is consistent with an efficient approach to access pricing.
  - (c) Third, we acknowledge that the ACCC has made important revisions to its cost allocation factors which previously overstated the costs of the Unconditioned Local Loop Service (ULLS) relative to other services.
- 1.3 However, Optus also has a number of significant concerns with the ACCC's proposed implementation of its new approach to access pricing.
  - (a) The ACCC has made two key 'uplifts' to Telstra's initial RAB, to inflate its value by more than \$1.8 billion above its unrecovered actual costs, with the stated purpose of achieving a ULLS price of \$16 in the six months to June 2011. This emphasis on price stability comes at a high cost. By valuing Telstra's assets higher than actual cost, the ACCC is proposing to gift Telstra a substantial windfall gain. Not only is this over-recovery inconsistent with the criteria in the Competition and Consumer Act, but it also defeats the purpose of the fundamental pricing reform the ACCC is undertaking. The purpose of a RAB roll-forward model is to ensure that Telstra recovers the costs it has incurred and no more. The proposed adjustments result in a RAB which is over-valued from the outset; thus making this objective impossible to achieve. More importantly it denies consumers the opportunity to benefit from lower access prices and does nothing to encourage further ULL roll-out in advance of the NBN. In this paper Optus will submit that the ACCC should set Telstra's initial RAB equal to depreciated actual cost. This change alone implies a weighted average ULLS price of \$15.50 / month: a substantial reduction which would revitalise fixed line competition and likely result in significantly lower retail prices for end users.
  - (b) There is a fundamental formula error in the way the ACCC has calculated a weighted average ULLS price for Bands 1 to 3. As detailed in section 2, the ACCC has used incorrect weights to calculate the average price for ULLS. This results in a substantial over-recovery of costs and means that ULLS access seekers – and their end user customers – will pay far more than their 'fair share' of Telstra's network costs. The

extent of the over recovery due to this error alone is in the order of \$135 million over the proposed regulatory period or \$1.78 per month for each end-user.

- (c) Optus is concerned about the proposal to maintain the geographic exemptions which deny regulated access to resale services in a number of exchange areas. The exemptions will not achieve the investment outcomes intended. Contrary to the ACCC's wishful thinking, the removal of access to regulated resale services is not a significant driver of investment in DSLAM infrastructure, particularly given the overriding impact of the NBN on investment decisions in the current climate. The only impact of this exemption is to enable Telstra to raise its wholesale prices without constraint in exempted exchange areas.
- (d) The so-called 'efficiency mechanism' which allows Telstra to recover its forecast levels of expenditure, as opposed to costs actually incurred, is deeply flawed. This approach will provide Telstra with both the incentive and the means to 'game the system' and recoup revenue substantially greater than its actual expenditure, leaving its wholesale customers to pay the difference.

1.4 In its discussion paper the ACCC has asked for stakeholders' views on a number of other specific issues. These issues are also covered later in this submission, where Optus will submit that:

- (a) the regulatory period should be no more than three years, in order to ensure that prices are more closely tied to costs actually incurred by Telstra (Section 5);
- (b) the proposed non-price terms and conditions are largely acceptable; however, industry certainty requires terms to be strengthened or introduced in a number of areas (Section 7);
- (c) NBN-based wholesale services should not be regulated, since there will be effective wholesale competition over the NBN. To add a further layer of regulation on top of the regulation of NBNCo's access prices would be inefficient and unnecessary (Section 8); and
- (d) the ACCC should adopt a cautious approach to setting 'fixed principles'. Given that we are at an early stage in the new regime it would be prudent to tread carefully before setting any rules in stone (Section 9).

1.5 Finally, Optus remains concerned about the ongoing payments Telstra will receive from NBNCo in exchange for access to Telstra infrastructure and the migration of customers from Telstra's copper and cable access networks to the NBN, together valued at \$9 billion in net present value terms. The ACCC appears to be minded not to take into account these substantial payments, either in its consideration of the initial RAB or in the context of ongoing regulatory depreciation. There is a real risk that Telstra will be compensated twice for its investment. It is even more concerning that the ACCC has flagged that it may reduce demand forecasts to take account of NBN migration when information becomes available, thus taking into account the impact of the NBN on one side of the ledger, but failing to take it into account on the other side.

1.6 In this paper Optus will submit that careful analysis of this issue is required in order to prevent double recovery. End users are entitled to have confidence that they will not be required to compensate Telstra twice over for its network investment. The ACCC should signal clearly that any consideration Telstra receives will be taken into account to ensure there is no risk of over-recovery – and to explain how this will be achieved.

## **Section 2. The Initial RAB and the ULLS Price**

- 2.1 In this section, the ACCC's new building block model (BBM) pricing methodology is discussed, and a number of key issues concerning the proposed implementation are set out, including:
- (a) the proposed inflation of the initial value of Telstra's RAB above actual cost;
  - (b) the improved viability of new infrastructure investment and ULLS-based competition that could be encouraged if a significantly lower ULLS price were set;
  - (c) the substantial over-recovery resulting from an error in the formula used to calculate the weighted average price for ULLS; and
  - (d) the ongoing payments Telstra will receive from NBNCo.
- 2.2 In summary, Optus is concerned that in its proposed implementation of the BBM, the ACCC appears to have placed excessive reliance upon 'price stability'. As a result the proposed approach will allow Telstra to recover revenue which exceeds its costs. This result would not promote competition, and is not in the interests of end users. Below Optus proposes an alternative approach which will provide end users with the opportunity to benefit from a more competitive environment and lower retail prices.

### **A new approach to pricing**

- 2.3 The ACCC has proposed access prices for the declared fixed line services in its draft final access determinations (FADs) which have been set according to a new methodology. Under the new method, prices are estimated using a 'building block' model (BBM), which accounts explicitly for each cost category or 'building block' faced by the regulated business. The ACCC will establish an initial value of the regulated asset base (RAB), which is then 'locked in' and 'rolled forward' by actual changes in the value of the asset base.
- 2.4 Optus supports the proposed transition to a pricing approach for fixed line services based on a BBM in which a RAB is rolled forward year on year. The ACCC's previous pricing methodology for the ULLS, known as total service long run incremental cost (TSLRIC+) was responsible for the overvaluation of Telstra's network assets, excessive access prices, price volatility and significant industry uncertainty. The ACCC's new BBM, which is both transparent and well documented, will increase the predictability of access pricing and enhance business certainty.
- 2.5 The new approach also has the potential to achieve cost recovery for the access provider, to encourage investment and to enhance competition through lower access prices. However, in order to achieve this potential, much depends on the implementation.

### **Setting the initial RAB**

- 2.6 A critical first step in establishing the new BBM approach to setting prices for access to Telstra's fixed line network is to assign a starting value to Telstra's network assets (the initial RAB). This step determines the total value of the investment for which Telstra will be compensated. Once the initial RAB has been determined, the value is 'locked-in' and will continue to be a key determinant of the level of access prices for the duration of the pricing regime.

## The cost recovery principle and depreciated actual cost

- 2.7 In setting the initial RAB, the guiding principle is that the access provider should be compensated for the actual investment it has made in its assets, and no more. This is consistent with judicial consideration of the legislative requirement that regard be had to the access provider's "legitimate business interests", which is a reference to "the interest of a carrier in recovering the costs of its infrastructure and its operating costs and obtaining a normal return on its capital".<sup>1</sup> This refers to the carrier being able to recover its actual investment.
- 2.8 In order to ensure that the access provider is not over- or under-compensated over the long-term, past compensation must be taken into account in setting an opening RAB. This is consistent with asset valuation requirements imposed in other sectors, for example, section 8.10(f) of the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code) recognised that past recovery of capital investment through tariffs and charges is highly relevant to the selection of an appropriate asset valuation methodology.<sup>2</sup> A similar approach is required for the valuation of fixed line telecommunications network assets.
- 2.9 In order to achieve these objectives, the most appropriate methodology for valuing Telstra's assets is depreciated actual cost (DAC). Under the DAC approach, the historic cost of an asset is adjusted by the proportion that the original investment cost has already been recovered. Optus has provided the ACCC with estimates of the unrecovered investment cost of Telstra's assets. In an expert report submitted in support of Optus' submission in response to the ACCC's 2010 Discussion Paper, adjustments were made to the DAC values reported in Telstra's regulatory accounts to account for changes in the price level and subsequent actual cost recovery (based on revenues received by Telstra). This resulted in values for Telstra's CAN in 2010 of between \$2 billion and \$6 billion. Alternatively, actual depreciation as recorded in the access provider's historical accounts may be used as an approximation for cost recovery, as the ACCC recognised in its September 2010 Draft Report. Optus notes that this approximation is conservative (in Telstra's favour).
- 2.10 The use of DAC to set an initial RAB has many recognised advantages, and is consistent with the legislative criteria which the ACCC is required to follow in setting access prices. In September 2010, the ACCC concluded that:

*using a DAC valuation will, on balance, best promote the access provider's legitimate commercial interests since it uses objective, verifiable data on past investments and depreciation. As noted below, it is also the preferred approach for promoting efficient future investment in sunk assets.<sup>3</sup>...*

*It is the ACCC's preliminary view that adopting a DAC methodology to value the relevant telecommunications infrastructure is in the LTIE, and will meet the legitimate commercial interests of the access provider.<sup>4</sup>*

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<sup>1</sup> Telstra Corporation Limited [2006] ACompT 4 at [89] (referred to with approval in Re Telstra Corporation Ltd (No 3) [2007] ACompT 3 at [180]).

<sup>2</sup> Re Application by East Australian Pipeline Limited [2004] ACompT 8 at [19], [29].

<sup>3</sup> ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.25

<sup>4</sup> ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.p.27

- 2.11 However, the ACCC now proposes to depart from this approach in setting the initial RAB to be used in its BBM to estimate access prices for the next regulatory period (and subsequent periods). In developing its proposed initial RAB value, the ACCC has used the DAC value as a starting point, but has then made two adjustments (that is, the indexation of land values by CPI and an increase in the value assigned to the ‘ducts and pipes’ asset class), both of which have the effect of inflating the RAB above the value given by the DAC methodology.
- 2.12 It is critical to step back and recognise the implications of this move. The ACCC’s proposed adjustments violate the principle that the access provider should be compensated for the actual investment it has made in its assets, and no more. By valuing Telstra’s assets higher than its residual costs, the ACCC is proposing to require access seekers – and end-users – to compensate Telstra for costs it has already recovered in the past. Regardless of the justification for this step, it will inevitably require end-users to pay for the initial investment twice over, delivering Telstra a substantial windfall gain.
- 2.13 Not only is this over-recovery inconsistent with the ‘legitimate business interests’ criteria in the Competition and Consumer Act, but it also defeats the purpose of the fundamental pricing reform the ACCC is undertaking. The purpose of a RAB roll-forward model is to ensure “financial capital maintenance”; that is, to ensure Telstra recovers its costs and no more. The ACCC has recognised this objective:

*The ACCC considers that the BBM pricing approach meets the objective of ensuring that the access provider is adequately compensated for its costs over time. As noted above, the BBM calculates the revenue required to cover the access provider’s efficient costs, including a commercial return on investments.*

- 2.14 However, the proposed adjustments result in a RAB which, from the outset, exceeds the value of Telstra’s unrecovered investment costs. The inevitable result of setting the RAB at this level is that Telstra’s revenue will be in excess of its efficient costs; thus making the objective of the BBM approach impossible to achieve.
- 2.15 In its discussion paper, the ACCC has noted the reasons for its proposed adjustments. These reasons are considered below. In summary, however, Optus considers that the reasons given do not provide adequate justification for a departure from the cost recovery principle.

### The land value adjustment

- 2.16 Regarding the first adjustment to the starting point DAC value, the ACCC proposes to accept Telstra’s argument that because land typically appreciates and does not deteriorate over time like other assets, it should not be depreciated, and that land asset values should be indexed to reflect the appreciation of land values over time. The ACCC has adopted the land values provided by Telstra which Telstra has indexed by the CPI since its last revaluation of land assets in 1991-92.
- 2.17 Optus submits that Telstra’s argument is flawed, and is based upon a misunderstanding of the ACCC’s proposed use of the DAC methodology, and a conflation of two alternative meanings of the word ‘depreciation’. The essential purpose of the DAC method for setting the initial RAB is to place a value on the proportion of the access provider’s original investment in its assets which has not yet been recovered. For setting the initial RAB, we are not interested in depreciation as a measure of the decline in the utility of the asset; rather, our sole interest is in depreciation as a measure of the return of the asset owner’s capital. Depreciation is used as an *approximation* for the past recovery of Telstra’s costs.



- 2.18 Given this purpose, it is irrelevant that land “does not deteriorate over time like other assets”. The continuing economic value of the land is beside the point; all that matters for setting the initial RAB is the extent of cost recovery. The key facts with regard to land are:
- (a) Telstra has incurred costs in order to purchase the land (just like any other asset); and
  - (b) Telstra has recovered a proportion of that investment cost (just like any other asset).
- 2.19 Therefore, for the purposes of setting the initial RAB, land should be treated in just the same way as any other asset. The value of the land asset should be reduced to reflect the assumed proportion of investment cost that Telstra has recovered.
- 2.20 Similarly, the fact that the market value of land has actually increased is irrelevant, since that fact has no bearing on the extent to which Telstra has recovered its investment cost. The historic appreciation in market value is thus irrelevant to setting the initial RAB. No CPI adjustment should be applied.
- 2.21 As an aside, it is worth considering the broader implications of Telstra’s argument. Telstra is effectively asserting that – at least for land – if market value diverges from DAC value, then the DAC value should be adjusted to reflect market value. But if this argument is accepted for this one asset class, then why should it not be applied to all asset classes? Neither Telstra nor the ACCC has advanced any reason in principle to treat land differently from any other asset. If the ACCC accepts Telstra’s argument in respect of land, then logically it should also estimate the market value of all of Telstra’s network assets. The market value of copper cable, for example, is likely to differ from its DAC value. But the approximation of the market value of the network was the underlying purpose of the MEA hypothetical cost models such as PIE II and the TEA model. That is, to accept Telstra’s argument is effectively to return to the failed TSLRIC approach of the past.
- 2.22 Further, if the value of Telstra’s land and building has increased over time, then Telstra will be able to realise that gain on the eventual disposal of those assets. So if the ACCC decides not to reflect such a gain in access prices, Telstra’s legitimate business interests will not be harmed.
- 2.23 Optus submits that the ACCC should apply the DAC approach consistently and reject differential treatment of the land asset class.

### The ducts and pipes adjustment

- 2.24 The second adjustment applied by the ACCC in calculating the initial opening RAB value was to increase the value assigned to the ‘ducts and pipes’ asset class by \$1.44 billion above its DAC value. The ACCC has advanced a justification for the ducts and pipes value adjustment which is unorthodox and quite unprecedented in its candour. “Guided by the principle that pricing stability is desirable”, the ACCC has “decided to maintain the \$16 ULLS price”, and has therefore “determine[d] a RAB value consistent with an averaged ULLS Band 1 to 3 price of \$16”. That is, the ACCC has ‘reverse engineered’ a \$16 ULLS price by deliberately inflating the value of Telstra’s network assets by \$1.44 billion, an adjustment which would not otherwise have been made. (Whilst an alternative justification for the adjustment has also been suggested, this appears to be a convenient fig leaf and not the real reason for the change – and is also based on a flawed argument.<sup>5</sup>)

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<sup>5</sup> The alternative reason advanced by the ACCC in support of the ducts and pipes adjustment was that the economic value of these assets was likely to be substantially higher than their depreciated historic values, due to their long lives and continuing economic use beyond the life of the current copper network. This argument is invalid for the same reasons as is the argument in favour of the land value indexation. Whether or not the ducts

- 2.25 Optus is concerned that such a substantial intervention has been justified primarily by ‘price stability’, a criterion of questionable relevance. The criteria against which any pricing principle must be assessed are set out in the relevant legislation (the Competition and Consumer Act). ‘Price stability’ does not appear in the Act, so this issue is of relevance only to the extent that it can be linked to one of the relevant criteria.
- 2.26 The ACCC has provided some explanation of the reasons behind its focus on price stability. It notes that pricing stability is “desirable to the extent that it supports past investments and promotes industry confidence in making future investment decisions”; then turns to a discussion of access seeker investments in DSLAM infrastructure, which have been made primarily in Band 2 metropolitan areas. The ACCC appears to imply that these investments depend upon price stability, and then links that stability to the “legitimate business interests” criterion in the legislation, stating that it considers that:
- ... it is important to protect the legitimate business interests of both access seekers and Telstra. This consideration has led the ACCC to conclude that a clear justification is required for any significant change in existing prices. Based on this view, the ACCC has decided to maintain the \$16 ULLS price...<sup>6</sup>*
- 2.27 This argument does not hold. It is not enough to note a connection between price stability and the “legitimate business interests” criterion, and on that basis to conclude that static prices will in all cases be preferable to changing prices. Rather, it is necessary to examine the impact of a proposed pricing principle on the legitimate business interests of access seekers and access provider (and on the other legislative criteria) in the particular circumstances under consideration.
- 2.28 Optus agrees that access seeker investments in DSLAM infrastructure have been made in reliance upon the Band 2 ULLS price. Certainly, it is in the legitimate business interests of access seekers that their infrastructure investments are not stranded by an increase in the key access price on which their business case depends. However, the adjustment which the ACCC is attempting to justify via this argument is an *increase* to the value of the RAB. If the adjustment is *not* made, then the ULLS price will be *lower*. Clearly a lower ULLS price will not adversely impact upon the infrastructure investments of access seekers, nor will it damage their legitimate business interests. Therefore it cannot be the case that the ducts and pipes adjustment is justified by the legitimate business interests of access seekers.
- 2.29 Likewise, it is difficult to discern any logical connection between a \$16 ULLS price and the legitimate business interests of Telstra. It is unclear which of Telstra’s own past investments have been made in reliance upon a ULLS price of \$16; in any event most of those investments were made long before the ULLS was declared. As the ACCC has itself recognised, “a cost based valuation approach that allows the access provider to recover its actual investment costs will

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and pipes asset has a longer life or continuing economic value is not relevant for the purposes of determining the opening RAB. We are not concerned with the extent of remaining utility of the asset, so we need not be concerned with the reasonableness of assumptions around its economic life. The primary consideration is the degree to which the original investment cost in the duct and pipe assets has been recovered. The DAC value as measured by the accounting records provides an approximation for the unrecovered investment cost of the asset. It follows that the DAC value is the appropriate valuation for ducts and pipes and no adjustment is appropriate.

<sup>6</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.47

best promote the legitimate commercial interests of the access provider.”<sup>7</sup> That is, asset valuation based upon DAC is consistent with Telstra’s legitimate business interests.

2.30 By contrast, the proposed inflation of the RAB above its DAC value is not only unnecessary; it is also contrary to the legislation, since it will allow Telstra to over-recover costs and earn profits in excess of a normal rate of return. As the Competition Tribunal has recognised, the access provider’s “legitimate business interests” do not extend to extracting monopoly rent or receiving a price that reflects the value of the network derived from its natural monopoly characteristics. It follows that it is not in a carrier’s legitimate business interests to make an above-normal return on its investment.

2.31 Nor would an inflation of the RAB be consistent with the other key criteria. A valuation of Telstra’s assets above cost results in higher access prices which can only discourage infrastructure investment by access seekers. Further, valuation above cost provides Telstra with an advantage over its competitors which is unlikely to promote competition. Competition is promoted where service providers face equivalent costs for access to the declared service. In order for access prices to promote competition, they must be no higher than Telstra’s costs of providing the service, as the Tribunal has noted:

*...In normal circumstances, one would expect an access seeker could only compete if Telstra’s ULLS charges reflected its costs of providing the service and if the access seeker were at least as efficient as Telstra in performing the other stages of the production process necessary to provide services to end-users. If ... the ULLS charges were above Telstra’s costs of providing the service, then Telstra would be able to reduce the price of retail line rental services to end-users below the price an access seeker could offer on account of it facing a lower cost than the access seeker pays for the ULLS.<sup>8</sup>*

2.32 It follows that setting an access price which is higher than Telstra’s depreciated actual costs would give Telstra a competitive advantage over access seekers and stifle competition in the provision of services to end-users. In such circumstances Telstra could price its retail services at a level at or below the access price without jeopardising its own capacity to make a profit.

2.33 Finally, it is important to recognise that lower prices for consumers are an important end result of a successful access pricing regime. This is reflected in the ACCC’s legislative objectives. The Competition Tribunal discussed the legislative objective which lay behind the promotion of competition concept in its 2007 decision on Telstra’s ULLS undertaking, where it stated:

*...the Act aims to promote competition because of the benefits that result from the process of competition, such as lower prices for consumers and the displacement of inefficient suppliers by efficient suppliers of services.<sup>9</sup>*

2.34 The ACCC’s proposed inflation of the RAB denies consumers the opportunity to benefit from the lower retail prices which would flow from the more competitive environment brought about through lower access prices.

2.35 In summary, it is clear that ‘price stability’ is not required in order to meet the legislative criteria. Optus submits that in order to meet the legislative criteria, the ACCC must value Telstra’s assets at DAC, and should not make either of its proposed adjustments. This implies

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<sup>7</sup> ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.25

<sup>8</sup> In *Telstra Corporation Limited* [2006] ACompT 4 at [110]

<sup>9</sup> *Telstra Corporation Ltd (No 3)* [2007] ACompT 3, para 99

that Telstra's 2009 initial RAB should be set at \$15.87 billion, taking into account removal of the indexation adjustment for land assets (\$0.44 billion) since 1991-92 and the uplift assigned to ducts and pipes (\$1.44 billion).

### Investment impact of a lower ULLS Price

- 2.36 In its discussion of price stability, the ACCC concludes that "a clear justification is required for any significant change in existing prices". A lower ULLS price is likely to improve the commercial viability of DSLAM investment and thus has the potential to encourage further DSLAM investment by access seekers. This provides a "clear justification" for such a move.
- 2.37 The Band 2 ULLS price is a significant driver of investment in DSLAM infrastructure, as the ACCC has implicitly recognised in its discussion paper. However, in that discussion the ACCC focussed only on price *stability* (and implicitly, the risks of a price increase) and on the legitimate business interests criteria; it did not consider the possible impact of a price *decrease* on other criteria, namely the encouragement of efficient investment in infrastructure, and the promotion of ULLS-based competition. A Band 2 ULLS price significantly lower than \$16 has the potential to encourage investment in DSLAMs by access seekers (particularly in Band 2).
- 2.38 In considering the potential stimulus to investment that could be obtained through a reduction in the ULLS price, it is important to consider the NBN. The imminent construction of the NBN affects the investment decision by reducing the time period in which operators can receive positive cashflows from any investment in DSLAMs. It thereby makes the economics of DSLAM investment less appealing. Significant further investment appears unlikely at current price levels. **CiC**
- 2.39 However, the ACCC has the ability to alter this position by making a market-changing access price reduction. The commercial viability of DSLAM investment is highly sensitive to the ULLS price. If the ULLS price was reduced significantly, this would substantially improve the economics of ULLS-based service provision. If regulated costs were substantially lower in the period before NBN construction, then further DSLAM investments could become economically viable for access seekers.
- 2.40 As Optus submitted above, the ACCC should set Telstra's 2009 initial RAB at its depreciated actual cost (DAC), \$15.87 billion, taking into account removal of the indexation adjustment for land assets (\$0.44 billion) since 1991-92 and the uplift assigned to ducts and pipes (\$1.44 billion). This change alone implies a weighted average ULLS price of \$15.50 / month (if the weighted average was calculated using SIO weights) or \$13.73 / month (if the weighted average was calculated using ULLS demand weights).
- 2.41 A reduction in the ULLS price of this magnitude has the potential to produce an uplift in DSLAM investment and a substantial increase in ULLS-based competition. **CiC**
- 2.42 Not only would this outcome enhance the quality of fixed line competition (through an increase in ULLS-based competition), but also it would have more lasting effects. By making access seekers more competitive with Telstra in the lead-up to the NBN it would lead to more equitable market shares leading into the NBN transition, impacting the competitive landscape in fixed line telecommunications for years to come. Further to these significant enhancements to investment and competition, Optus' proposal would prevent the cost over-recovery by Telstra which would otherwise be caused by the proposed upward adjustments to the RAB.

- 2.43 Finally, the savings in input costs resulting from a ULLS price lower than \$16 could be passed on to consumers through the process of competition between ULLS access seekers and Telstra. A reduction in the ULLS price would therefore bring significant benefits to end users through lower retail prices (which is an important and recognised consequence of the promotion of competition<sup>10</sup>).

### **ULLS price averaging**

- 2.44 The ACCC has proposed to set a uniform monthly ULLS price which is averaged across Bands 1 to 3, at a level of \$16 to June 2011, and \$16.75 from July 2011. This averaged price deviates significantly from the de-averaged prices produced by the fixed line cost model for Bands 1 to 3 over the five year regulatory period (1 July 2011 to 30 June 2016), which are as follows:

- (a) Band 1: \$4.80;
- (b) Band 2: \$15.13; and
- (c) Band 3: \$23.72.

### **Averaged ULLS pricing will not achieve the ACCC's investment objectives**

- 2.45 Whilst the ACCC has cited a number of reasons for its decision to set an averaged price for ULLS (including administrative simplicity and industry stability), a key factor in the decision appears to have been the ACCC's view that an averaged ULLS price would result in lower prices in Band 3 and thereby promote DSLAM investment in Band 3 exchanges.

- 2.46 **CIC** Whilst it is correct that the DSLAM investment decision is sensitive to the ULLS price, there are also a number of other factors which must be taken into account, and which militate against investment in Band 3:

- (a) First, a large proportion of addresses in Band 3 exchanges have distance limitations which impose a technical barrier to DSLAM-based service provision. Both the ACCC and the Australian Competition Tribunal have previously noted this limitation:

*...The Commission pointed out that the ... the ability of the ULLS to provide xDSL services to end-users was dependent on the length of the copper wires that comprise the ULLS...The Commission referred to a report prepared by Frontier Economics ... which stated, in relation to xDSL services provided over the ULLS, that:*

*The speed of service delivery deteriorates as the distance of the customer from the exchange increases. ... The rate at which speed deteriorates with customer distance from the exchange varies with the form of DSL technology used. In general however the speed falls significantly when customers are more than 2 km from the exchange and it is not technically possible, using xDSL technology, to ensure 'broadband' speeds when customers are located more than approximately 5-6 km from the exchange.<sup>11</sup>*

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<sup>10</sup> Telstra Corporation Ltd (No 3) [2007] ACompT 3, para 99

<sup>11</sup> Telstra Corporation Limited (No 3) [2007] ACompT3 para 135

- (b) Second, for a DSLAM investment to be economic requires that a threshold number of subscribers can be won. On plausible market share assumptions, most Band 3 exchanges do not have sufficient population to justify a DSLAM investment.
- (c) Third, the NBN is likely to be rolled out largely on an “outside-in” basis; that is, it will be deployed in rural areas before it is deployed in urban areas.<sup>12</sup> Consequently, the time period in which operators can receive positive cashflows from any investment in DSLAMs will be significantly shorter in Band 3 compared to Band 2, and the economics of DSLAM investment in Band 3 are far less appealing compared to investment in Band 2, irrespective of ULLS price levels.
- 2.47 **CiC** A decision to set an averaged ULLS price in Bands 1 to 3 will not, therefore, produce the investment increase in Band 3 which the ACCC is hoping for.
- 2.48 De-averaged ULLS prices, on the other hand, has the potential to encourage further investment in DSLAM infrastructure by access seekers – in Band 2 exchanges. As noted above, the de-averaged Band 2 ULLS price for the five year regulatory period (1 July 2011 to 30 June 2016) is \$15.<sup>13</sup> The economics of investment in Band 2 are considerably more attractive than Band 3, given that Band 2 exchanges are not subject to the disadvantages noted above which apply to Band 3. **CiC** And for the reasons explained above, de-averaging would not discourage investment in Band 3 (since such investment is not attractive even under averaged prices).
- 2.49 In summary, if the ACCC wishes to stimulate further DSLAM investment and create a lasting improvement in the competitive environment, it should focus its attention on Band 2, where a lower ULLS price is capable of stimulating significant advances in investment and in competition.

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<sup>12</sup> This sequence may be considered efficient, given the existing infrastructure in place (urban areas have faster broadband already as the result of competing networks) and it is also the result of political considerations (the Government’s agreement with the rural independent MPs).

<sup>13</sup> Note that the valuation of the initial RAB at DAC, as recommended above, has not been taken into account in the calculation of this value.

The weighted average price causes over-recovery of ULLS-related costs

2.50 In order to determine the level of its proposed uniform price for Bands 1 to 3, the ACCC has applied a weighted average formula using weights based on the share of total SIOs for all services (including WLR and Telstra retail services) in each band:

*In averaging the ULLS Band 1 to 3 price, the ACCC has weighted the band prices estimated by the FLSM by the share of **total SIOs** in each band.<sup>14</sup> [emphasis added]*

2.51 This approach disregards the fact that the ULLS is overwhelmingly concentrated in lower cost Band 2 metropolitan areas. As a result, it causes substantial over-recovery: Telstra will recover revenue from ULLS access seekers and their end user customers which exceeds its ULLS-related costs by \$135 million over the five year regulatory period.<sup>15</sup>

2.52 Questions of recovery (or over-recovery) of costs may be examined by comparing two figures, both derived from the fixed line services model (FLSM):

- (a) the revenue requirement allocated by the FLSM to be recovered through the ULLS (that is, ULLS-related costs); and
- (b) the revenue forecast by the FLSM to be recovered through the ULLS (using the model's forecast demand and the proposed total SIO-weighted average ULLS price set in the FAD).

2.53 In order to achieve cost recovery, these two figures, (1. the revenue requirement and 2. the revenue forecast) should be equal. However, under the proposed approach to calculation of a weighted average ULLS price, (2.) exceeds (1.) in every year. By definition, this means that Telstra will recover revenue in excess of its costs. The over-recovery is significant – up to 17% of the revenue requirement – as set out in the following table.

	2011/2012	2012/2013	2013/2014	2014/2015	2015/2016
<b>Total ULLS Revenue Requirement</b> (nominal, \$m)	188	202	217	215	218
<b>Forecast revenue using SIO-weighted average ULLS price (proposed FAD)</b>	220	231	242	242	242
<b>Level of over recovery</b> (nominal, \$m)	31.5	28.5	24.9	26.6	23.7
	<b>17%</b>	<b>14%</b>	<b>11%</b>	<b>12%</b>	<b>11%</b>

2.54 Why does the proposed approach not achieve recovery of ULLS-related costs? Because the weights used in the calculation of the weighted average price are incorrect.

<sup>14</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.144

<sup>15</sup> When an average price is calculated using weights based on the share of total SIOs in each band, the weighting assigned to (lower cost) Band 2 areas is lower than the share of Band 2 SIOs in total ULLS SIOs, and the weighting assigned to (higher cost) Band 3 areas is higher than the share of Band 3 SIOs in total ULLS SIOs. This means that the total revenue Telstra earns from ULLS (that is, the average price multiplied by the total number of ULLS SIOs), must exceed the total costs allocated by the model to be recovered through the ULLS. That is, when an average price is calculated using weights based on the share of total SIOs in each band, the result is over-recovery.

### *The correct calculation of a weighted average price*

- 2.55 When an average ULLS price is calculated, in order for forecast revenue to remain equal to ULLS-related costs (ie, the revenue requirement for ULLS), the unit ULLS price in each band must be given a weight in the calculation which reflects the contribution of the ULLS in that band to total ULLS-related costs.<sup>16</sup> The contribution of the ULLS in a given band to total ULLS-related costs (ie the ULLS revenue requirement) is proportionate to the relative number of ULLS SIOs in that particular band. So the correct weighting must reflect the relative number of ULLS SIOs in each band, as in the following equation:

$$P_{VWAP} = \frac{\sum_j P_j \cdot Q_j}{\sum_j Q_j}$$

where:

PVWAP = volume-weighted average price

P<sub>j</sub> = unit price in Band j

Q<sub>j</sub> = number of ULLS SIOs in Band j

- 2.56 Optus has used the FLSM to calculate the forecast revenue which results from applying a volume-weighted (or demand-weighted) average ULLS price, with weights based on the share of ULLS SIOs in each band. If an average ULLS price is calculated using this equation then the revenue requirement and the revenue forecast are approximately equal in every year. (Refer to Appendix A for details of these calculations.) By definition, this means that – according to the internal logic of the model – Telstra will achieve cost recovery (and not over-recover).
- 2.57 If, however, the weighting for a given band exceeds the correct weighting (which reflects the relative number of ULLS SIOs), then the unit cost associated with that band will be given an excessive weight in the analysis, disproportionate to that band’s contribution to ULLS-related costs. If the unit cost associated with that band is relatively high (as is the case with Band 3), then the erroneous weighting will cause the resulting “average” ULLS price to be too high, and result in ULLS revenue which exceeds ULLS-related costs (ie, the revenue requirement for ULLS).

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<sup>16</sup> The disaggregated unit price calculated by the model for each of the four bands is a reflection of the unit cost per SIO in each band, and is derived directly from the ULLS revenue requirement by taking into account ULLS volume in each band (as set out in the ACCC’s Discussion Paper at section 10.3.2, p.128-9, and at section 11.3.3, p.142). The number of ULLS SIOs in each band is a critical determinant of the share of costs allocated to the ULLS.

*“To calculate the geographically-adjusted cost allocation factor for ‘ducts and pipes’ for ULLS, the total ‘ducts and pipes’ cost of supplying ULLS is calculated by weighting the estimated ‘ducts and pipes’ costs per band by **the number of ULLS SIOs in each band**. The total ‘ducts and pipes’ cost for ULLS is then divided by the total ‘ducts and pipes’ cost of supplying all services (that is, ULLS, WLR and Telstra’s retail services) to obtain the cost allocation factor.” [emphasis added] (ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.129).*

The revenue requirement allocated to be recovered through the ULLS is determined by taking into account the fact that the ULLS is predominantly purchased in (lower cost) Band 2 areas. When individual band prices are calculated, the revenue requirement allocated to be recovered through the ULLS is distributed between the bands based on the number of SIOs in each band and the relative costs of each band.



### *A hypothetical example*

- 2.58 To illustrate how this works, consider a hypothetical example, with the following assumptions:
- (a) 100 ULLS SIOs, of which:
    - (i) 99 are located in Band 2 and
    - (ii) only 1 is located in Band 3
  - (b) total SIOs evenly distributed between Bands 2 and 3 (50% in each band)
  - (c) unit cost per ULLS SIO in Band 2: \$50
  - (d) unit cost per ULLS SIO in Band 3: \$500
- 2.59 In this example, total ULLS-related costs are \$5,450, comprising \$4,950 in Band 2 (=99 x \$50) and \$500 in Band 3 (=1 x \$500), so the revenue requirement for ULLS is \$5,450. The cost-reflective unit price per ULLS SIO in Band 2 is \$50 (= \$4,950 / 99) and the cost-reflective unit price per ULLS SIO in Band 3 is \$500 (= \$500 / 1).
- 2.60 The volume-weighted average price for ULLS, calculated using weights derived from the number of ULLS SIOs in each band, is \$54.50 (= \$50 x 99/100 + \$500 x 1/100). The revenue derived by the service provider in this example from ULLS access seekers using the volume-weighted average price is \$5,450 (= \$54.50 x 100), which is exactly equal to the revenue requirement for ULLS.
- 2.61 On the other hand, if weights derived from the number of total SIOs in each band are used, the resulting average price for ULLS is \$275.00 (= \$50 x 50% + \$500 x 50%). The revenue derived by the service provider from ULLS access seekers using the total SIO-weighted average price is \$27,500 (= \$275 x 100), which is more than five times the revenue requirement for ULLS! In this example, *the total SIO-weighted average price causes over-recovery of ULLS-related costs by more than 400%. Why? Because the wrong weights are used to calculate the average price. The high unit cost in Band 3 has a substantial impact on the average, disproportionate to the actual contribution of Band 3 to ULLS-related costs (which is low because only 1% of subscribers are located in Band 3).*
- 2.62 Clearly the numbers in this example have been chosen for the purposes of illustration; however when we consider the proposed average ULLS price in the draft FAD, the principle is exactly the same. The proposed average price cannot achieve recovery of ULLS-related costs, since the weights used in the calculation are based on a factor (the band's share of total SIOs for all services) which is unrelated to the contribution of ULLS SIOs in that band to total ULLS-related costs. The unit costs of Band 3 are over-represented in the weighted average, and the unit costs of Band 2 are under-represented. The resulting monthly price, \$16.75, is greater than the actual volume-weighted average in every year of the determination and the inevitable result is that Telstra over-recovers revenue from ULLS access seekers which exceeds ULLS-related costs. The over-recovery is significant, at up to 17% of the revenue requirement (as set out in the table above) which amounts to \$135 million over the five year regulatory period.

### *Relationship with cost allocation*

- 2.63 The impact of this error in setting the weights in the formula is unfortunate, in that it exactly cancels out the positive steps taken by the ACCC in developing its cost allocation factors.

2.64 Elsewhere in its discussion paper, the ACCC has acknowledged that the cost allocation factors it previously used for duct and pipe and copper cable assets overstated the costs of the Unconditioned Local Loop Service (ULLS) relative to other services,<sup>17</sup> since they did not reflect the differential costs of providing services in the different geographic bands. It recognised that the method previously used to set the cost allocation factors did not take into account the different distribution of the ULLS, the WLR and other services across the geographic bands, and that the costs allocated to the ULLS could be overestimated by this approach.<sup>18</sup> In response to this concern, the ACCC developed a methodology to adjust the allocation of costs to ULLS, WLR and other services (mainly Telstra's retail services) in order to reflect those differential geographic costs.<sup>19</sup> Using this methodology, the ACCC has carefully calculated the correct share of duct and pipe costs and copper cable costs which should be borne by the ULLS service, by revising its cost allocation factors for these assets. For example:

*Step 5: To calculate geographically-adjusted cost allocation factors for the 'ducts and pipes' and 'copper cables' asset classes for ULLS, the total revenue requirement allocated to ULLS for each asset class is calculated by multiplying the 'basic cost' in each band (at step 3) by the number of ULLS SIOs in each band and summing to obtain the total ULLS revenue requirement for 'ducts and pipes' and for 'copper cables'. For each asset class, the total ULLS revenue requirement is then divided by the aggregate revenue requirement (from all services using that asset class) to obtain the cost allocation factor for ULLS.<sup>20</sup>*

2.65 As a result of this process, it is apparent that the revenue requirement which the FLSM allocates to be recovered through ULLS access prices (from ULLS access seekers and their customers) does appropriately reflect the differential costs of providing services in the different geographic bands, according to the relative number of ULLS SIOs in each band. It is unfortunate that after applying this method so carefully to determine the ULLS revenue requirement, when it comes to determining the access prices through which the revenue requirement will be recovered, this information is completely disregarded, and an average price is set which does "not take into account the different distribution of the ULLS, the WLR and other services across the geographic bands". (Note that this is exactly the criticism of the previous cost allocation process which the ACCC has accepted.) The incorrectly calculated average price will cause Telstra to recover revenue in excess of the ULLS revenue requirement – thereby undoing all of the ACCC's good work on cost allocation.

2.66 Optus submits that the ACCC should revise its approach and calculate the average ULLS price by taking into account the share of ULLS end users in each band. According to the FLSM, correcting the weighting error in this manner would result in an 11.6% reduction in the ULLS price to the correct level of \$14.81 / month. Not only would the resulting ULLS price achieve cost recovery; but it could also encourage investment in Band 2 DSLAMs CiC and hence boost competition in downstream markets and allow lower retail prices for end users.

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<sup>17</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.128

<sup>18</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.136

<sup>19</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, pp.140-142 and 151-153

<sup>20</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.153

*'Price stability' does not justify an average price weighted by total SIOs*

2.67 In its discussion paper, the ACCC notes that it has considered weighting the band price estimates using the share of ULLS SIOs in each band (ie, using 'demand weights'); but this approach was rejected on the grounds of price stability, as noted in the following quotation:

*Using demand weights could result in significant changes over time in the averaged price if the pattern of demand across bands were to change significantly (even if the estimated underlying band prices remained constant). As noted above, there is potential for an increase in competition in Band 3, which could change the relative shares of ULLS SIOs across the bands. The ACCC concluded that using SIO weights was preferred as it would provide greater price stability than using demand weights.<sup>21</sup>*

2.68 To draw out what this means, consider that the 'instability' or change in the ULLS price about which the ACCC is concerned is said to be caused by an increase in competition (that is, an increase in ULLS SIOs) in Band 3. If this increase was large enough to significantly increase the proportion of ULLS SIOs in Band 3 relative to Band 2, then (given that the unit cost of ULLS in Band 3 is relatively high) a 'demand-weighted' average ULLS price would increase. The ACCC does not report on any attempt to quantify this concern.

2.69 So, to summarise, it appears that the ACCC considers that:

- (a) adopting a 'demand-weighted' average ULLS price could lead to a rapid ('unstable') increase in that price over time which is of greater magnitude than the increase if total SIO weights were used, *and*
- (b) this greater likelihood of change in the price is a negative impact (in terms of the legislative criteria) which outweighs any other considerations which might count against the use of total SIO weights (such as the fact that it allows Telstra to recover revenue which exceeds the ULLS revenue requirement).

2.70 Optus considers that neither (a) nor (b) is correct, and consequently the ACCC's concerns over the use of demand weights are not well founded.

2.71 Optus has carried out some analysis in order to quantify the plausible magnitude of any increase in the demand-weighted average ULLS price. The results of this analysis (which is discussed in more detail in Appendix A) are as follows:

- (a) the maximum plausible increase in ULLS SIOs in Band 3 which could eventuate over the five year regulatory period with a demand-weighted average price is approximately **CiC**;
- (b) the maximum plausible change in the proportions of ULLS SIOs over the five year regulatory period is that the proportion of Band 2 SIOs decreases to 93.5% (assuming *only a 7% year on year<sup>22</sup> increase* in Band 2 SIOs) and the proportion of Band 3 SIOs increases to 4.3%; and

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<sup>21</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.144

<sup>22</sup> This 7% year on year growth assumption has been taken to be the average annual increase in ULLS total SIOs allowed by the ACCC over the modelled regulatory period in the FLSM.

- (c) the demand-weighted ULLS price increases as a result from \$14.81 in the current regulatory period to a maximum of \$15.27 within the bounds of the current regulatory period (*ceteris paribus*).
- 2.72 Optus notes that the assumptions used in this analysis have been chosen in order to find the *maximum* plausible change in demand weights. For example, we have assumed that demand for ULLS increases substantially in Band 3, with much slower growth in Band 2. (In fact, Optus considers that demand growth in Band 3 is unlikely to out-pace growth in Band 2, as a result of those factors discussed above which render investment in Band 3 less appealing compared to Band 2, namely distance limitations to DSLAM-based service provision, insufficient population and “outside-in” NBN deployment. **CiC**) So in reality the change in SIO proportions between the bands is likely to be much smaller than this analysis suggests.
- 2.73 Nevertheless, despite making assumptions which are ‘biased’ towards change in the proportion of SIOs, leading to the maximum plausible increase in the demand-weighted ULLS price, that price still increases by *less than 46 cents over five years* – a change in the ULLS price which is less than the increase the ACCC is proposing to make on the 1<sup>st</sup> of July this year, by introducing the \$16.75 SIO-weighted price proposed in the draft FAD. Thus we can conclude that rapid (‘unstable’) ULLS price increases are unlikely to be a significant problem if demand weights are used, as opposed to total SIO weights.
- 2.74 Even if this analysis was not accepted, however, and price instability was considered a realistic possibility, this would not be a conclusive argument in favour of the use of SIO weights to calculate an average ULLS price. As noted earlier in this submission, price stability is of relevance only to the extent that it can be linked to one of the relevant legislative criteria. The ACCC makes no explicit link between price stability and the criteria at this point in its discussion paper. Earlier in the paper, however, it noted that pricing stability is “desirable to the extent that it supports past investments and promotes industry confidence in making future investment decisions” in the context of a discussion of access seeker DSLAM investments in Band 2 areas, and linked price stability to the “legitimate business interests” criterion.<sup>23</sup> The relevant issue, then, is not whether a demand-weighted average ULLS price is consistent with ‘price stability’; rather, the ACCC is bound to consider whether a demand-weighted average ULLS price is consistent with the legitimate business interests of access seekers and of the access provider.
- 2.75 As noted above, even after the maximum plausible increase in the demand-weighted ULLS price, it is still *less than* the \$16.75 SIO-weighted price that the ACCC is proposing in its draft FAD. Consequently, access seekers’ DSLAM investments will not be stranded as the result of the adoption of a demand-weighted ULLS price (as opposed to a total SIO-weighted ULLS price). So we can conclude that a demand-weighted average ULLS price is consistent with the legitimate business interests of access seekers.
- 2.76 And as demonstrated by the FLSM (and as set out in the table above), a demand-weighted average ULLS price achieves recovery of Telstra’s investment costs. On this basis we can conclude that a demand-weighted average ULLS price is consistent with Telstra’s legitimate business interests. And it would allow consumers the opportunity to benefit through lower retail prices, which is consistent with the promotion of competition.<sup>24</sup>

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<sup>23</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.47

<sup>24</sup> Telstra Corporation Ltd (No 3) [2007] ACompT 3, para 99

- 2.77 A total SIO-weighted average ULLS price, by contrast, allows Telstra to substantially over-recover its costs (as demonstrated by the FLSM and as set out above). Not only is this direct impact a violation of the “legitimate business interests” criterion, but there is also a significant indirect impact on the “promotion of competition” criterion. A ULLS access price in excess of Telstra’s costs drives a wedge between the costs faced by Telstra and those faced by its competitors in serving the same market. That is, it tilts the playing field decisively in Telstra’s favour, allowing it to undercut its competitors through the retail price, to “give less” in terms of its service offering, or simply to “charge more” and reap monopoly profits from its retail customers. A total-SIO weighted average ULLS price would prevent competition on the merits and hand Telstra significant market power. And it would deny consumers the opportunity to benefit from the lower retail prices which would flow from a demand-weighted ULLS price.
- 2.78 In summary, Optus submits that adoption of a demand-weighted average price would not cause significant price instability; however, notwithstanding this, the ACCC’s proposed use of total SIO weights to calculate an average ULLS price is contrary to the legislative criteria. The ACCC should calculate its average ULLS price weighted by the proportion of ULLS SIOs in each geographic band.

### **NBNCo compensation and duct rental payments**

- 2.79 Optus remains concerned about the payments of \$9 billion in net present value terms which Telstra will receive from NBNCo in exchange for access to infrastructure and the progressive migration of customers from Telstra’s copper and cable access networks to the NBN.<sup>25</sup>
- 2.80 The ACCC appears to be minded not to take into account these very substantial payments, either in its consideration of the initial RAB or in the context of ongoing regulatory depreciation. Further, the ACCC has flagged that it may reduce demand forecasts to take account of NBN migration when information becomes available. This would have the effect of providing compensation to Telstra through higher calculated prices because its customers have migrated to the NBN without accounting for the compensation from NBNCo which is designed to address that very cost.
- 2.81 Optus submits that migration payments should be viewed as a ‘return of capital’ to Telstra shareholders for capital invested in the CAN. Accordingly, once received Telstra should no longer earn either a return on capital or a return of capital associated with the asset for which the payment was made. So the asset value should be removed from the RAB. Further, a large component of NBNCo’s lease payments to Telstra will relate to the use by NBNCo of assets which form part of Telstra’s RAB(s) for fixed line services (as discussed in a previous Optus submission<sup>26</sup>). Ducts, trenches and pits form part of the RAB for the CAN. Compensation for the use of RAB assets is a component of total compensation to Telstra, which represents a ‘return of capital’ to shareholders for capital invested in the network. Accordingly, the ACCC should deduct this RAB-related element of lease payments from Telstra’s RAB for fixed line services.

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<sup>25</sup> Telstra, *Transcript: Telstra Conference Call*, 21 June 2011.

<sup>26</sup> Optus, *Submission in response to the Draft Report Telecommunications Access Pricing Principles for Fixed Line Services*, October 2010, Section 5

- 2.82 Both the RAB and regulatory depreciation deal with compensating Telstra for its capital investment in its network. Given that this is the same investment for which NBNCo will compensate Telstra, there is a very real risk that Telstra will effectively be compensated twice for the same investment.
- 2.83 Optus considers that extensive quantitative analysis of this issue is required in order to prevent double recovery. Once sufficient information is available on the timing and terms of the payments the ACCC should either commission or undertake a modelling exercise to examine this issue. Specifically, the quantitative analysis should aim to determine the most appropriate and equitable manner to account for the changes having regard to timing considerations and a smooth transition to the next regulatory arrangements under the NBN.
- 2.84 End users are entitled to have confidence that they will not be required to compensate Telstra twice over for its network investment. Further, end users which are last to migrate should not be left any worse off than the first. Optus submits that it would be appropriate for the ACCC to signal clearly that any consideration Telstra receives from NBNCo will be taken into account to ensure there is no risk of over-recovery – and to explain how this will be achieved.

## Section 3. PSTN OTA Price Structure

- 3.1 Optus welcomes the ACCC's detailed examination of the PSTN OTA pricing structure.
- 3.2 The existing rate table was first accepted by the ACCC in 2004, although its development pre-dates this by several years. It reflects an outdated view of the historic cost drivers for PSTN origination and termination. Accordingly, the problems associated with the existing rate table are well documented, being:
- a) Reliance on the flawed PIE II model and outdated information;
  - b) Inclusion of an access deficit contribution (ADC); and
  - c) That it reflects a cost structure that is no longer relevant.
- 3.3 It is essential that the approach to pricing of PSTN OTA changes, and that the existing rate table is no longer used.
- 3.4 The ACCC has proposed two options to change the PSTN OTA pricing table:
- a) To revise the existing table by removing the ADC and rebalancing the tariffs to reflect more recent traffic patterns; or
  - b) To construct a single, national rate this is consistent with the output from the FLSM.
- 3.5 Below Optus will assess the ACCC's two options and will argue that:
- a) The proposal to revise the existing price structure has a number of shortcomings as it fails to adequately address the significant problems inherent in the current structure and is inconsistent with market developments; and
  - b) A single rate presents significant benefits compared to the alternative of revising the existing structure and will promote competition.
- 3.6 This position is consistent with the economic analysis of the efficiency properties of PSTN OTA pricing which is set out in the attached CEG report (Attachment 1). CEG find that a uniform national price is the price structure for PSTN OTA which would allow the recovery of Telstra's sunk network costs with the least possible distortion to calling patterns.

### Option 1: Amend the existing rate table

- 3.7 As the ACCC has recognised, amending the existing rate table will require significant changes to be made to its structure. This will include removal of the ADC component and revisions to the relative tariffs to reflect more recent traffic patterns. Even with these changes a revised rate table will still present further problems, including:
- a) The unreliability of the source data – namely the PIE II model;
  - b) Dependence on static traffic patterns in a dynamic environment;
  - c) That it is not reflective of current cost structures;
  - d) Inconsistency with retail pricing plans in the market; and

- e) That it would need to change in any event to accommodate the migration of services to the NBN.

3.8 Each of these is discussed in the sections below.

*The PIE II model is flawed - should not form the basis of any prices*

3.9 The PIE II model, which underpins the geographic differences in prices, was developed by Telstra. It was lodged with the ACCC in support of its 2003 ULLS undertaking. The PIE II model is a total element long-run incremental cost (TELRIC) model that estimates the forward looking costs of supplying the ULLS. It primarily relates to the costs of installing, maintaining and operating the copper wire (and ancillary equipment) in the customer access network as well as other associated indirect costs.<sup>27</sup>

3.10 Although the PIE II model was developed to establish the costs of ULLS, the ACCC relies on the PIE II model for the estimates of cost relativities between the bands. That is, the differences in costs estimated by the model for each band are used to disaggregate headline rates deemed appropriate by the ACCC for the PSTN OTA service.

3.11 The ACCC has previously expressed concern with the relative cost estimates generated by the model, stating in 2003 that:

*The Commission's own examination of [Telstra's] PIE II model has shown the following:*

- *Its estimates of headline conveyance costs are not unlike those produced by the n/e/r/a model; and*
- *Its **estimates in non-urban areas are significantly higher** than those produced in previous models and in particular the n/e/r/a model, but that its estimates in urban areas are significantly lower.*<sup>28</sup> [emphasis added]

3.12 The specific concerns regarding the cost relativities between the bands were reiterated by the ACCC in the Discussion Paper as:

- a) By assuming copper is used to provide services in remote areas, even where more efficient and less costly technologies (such as radio, fixed wireless or satellite) are used in practice, the model grossly overstates the relative cost of providing services in Band 4;
- b) By imposing a grid pattern on the design of the network, the model significantly overstates trench lengths and copper wire lengths which further increases costs in areas where distances are greater (that is, rural and remote areas); and
- c) The simplified engineering rules used to dimension network elements distort the cost relativities between bands.<sup>29</sup>

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<sup>27</sup> Re Telstra Corporation Ltd (No3) [2007] ACompT3, para 329-330

<sup>28</sup> ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p.30

<sup>29</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.141



3.13 Given that the PIE II model is currently used specifically to provide information on cost relativities, these significant concerns described by the ACCC undermine the continued use of a geographic price structure for PSTN OTA services that is underpinned by the PIE II model. By simply updating the price matrix the fundamental problem of the reliance on the PIE II model is not rectified. Consequently, the relative costs between the bands remain based on a flawed model and so are unlikely to be an accurate reflective of the 'true' cost relativities.

3.14 Furthermore, the Australian Competition Tribunal has reiterated deep concerns about the reliability and accuracy of the PIE II model. It concluded that:

*...we cannot be confident, nor can we be satisfied that the PIE II model can be relied upon accurately to estimate Telstra's network costs...*<sup>30</sup>

3.15 Given these concerns, it is clear that the PIE II model should be completely disregarded in determining new PSTN OTA prices. Indeed, the ACCC stated that:

*it does not have updated cost information to verify that the costs estimated from the PIE II model are an accurate reflection of current actual costs.*<sup>31</sup>

#### Traffic profiles are dynamic - rates require frequent revision to remain relevant

3.16 The PIE II model relies on historic traffic profiles from 2003 (if not earlier) to derive the price matrix. However, traffic profiles have significantly changed since that time, driven by a shift to mobile services, shorter call duration and a substantial uptake of ULLS in metropolitan areas. These trends are expected to continue to influence traffic patterns for PSTN OTA services.

3.17 This means that the existing traffic profiles and assumptions on which the current rate table are based are inconsistent with the actual traffic profiles on which access charges are levied. This disconnect is likely to lead to significant differences in terms of what access seekers pay and likewise, what Telstra receives.

3.18 The ACCC has undertaken a comparative analysis of traffic profiles and found that:

*Since 2003, the share of OTA traffic in the CBD has increased marginally while the share of traffic in the provincial area has decreased marginally. Larger changes occurred in the metropolitan area, where its share of traffic has fallen, and in the rural area, which experienced growth in its share of traffic.*<sup>32</sup>

3.19 What this statement implies is that more traffic will be rated at rural than anticipated, which will result in a significant risk of cost over-recovery by Telstra.

3.20 Further, the ACCC has also obtained information which proves Optus' contention that actual average call durations are significantly different from the assumption. It has found that since

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<sup>30</sup> Re Telstra Corporation LTD (No3) [2007] ACompT3, para 366

<sup>31</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.149

<sup>32</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.146

2003 “the average call holding time has decreased significantly.”<sup>33</sup> The information provided also shows that **CiC**

- 3.21 Given the above points it is clear that if a rate table is adopted it will require frequent revision to ensure it is reflective of traffic patterns otherwise it will result in over-recovery. This will increase the regulatory burden on both Telstra and access seekers, in addition to the administrative costs of an unnecessarily complex pricing structure.

Existing price structure is not reflective of current cost structure

- 3.22 The existing price structure reflects an underlying assumption that:

- a) There are costs incurred for each call which is made (call set-up costs); and
- b) The costs to provide conveyance differ substantially between geotypes (bands).

- 3.23 These assumptions, and the models used to justify them, have been considered substantial enough to warrant a complicated pricing structure. However, given technological change and a greater understanding of Telstra’s network, it is clear that these assumptions are no longer valid.

- 3.24 The costs to provide the PSTN OTA are all fixed when measured on a per call, or minute basis. That is, there are no incremental costs that are specifically incurred because a call is made, nor are there costs being incurred each minute that a call continues. The costs that are associated with the assets utilised to provide access to the service are incurred whether calls are made or not. Therefore, the price structure imposed should cause the least distortion as possible to recover these sunk costs. Given the significant capacity available in the network, providing interconnection to access seekers does not impose any incremental costs to Telstra so an average price is an efficient way to recover these costs. This is examined in further detail in the attached CEG report (see Attachment 1).

- 3.25 Indeed, during its consultation on the Analysys Model, the ACCC stated that it:

*considers that the costs associated with transit are **likely to be the same** throughout the CAN and/or inter-exchange network (CORE) notwithstanding the geographical location of the end-user. This is similar to the approach taken in regard to the Mobile Terminating Access Service (MTAS) where a single per minute rate is set as the indicative price across the country.*<sup>34</sup> [emphasis added]

- 3.26 In summary, maintaining the existing rate table, even with the ACCC’s revisions, will fail to appropriately reflect current cost structures and will result in over-recovery of Telstra’s costs.

- 3.27 **CiC**

The continued rate structure is not reflective of retail pricing

- 3.28 There are currently no retail offers that resemble the pricing structure of the existing PSTN OTA rate table. It is also highly unlikely that retail pricing will move in the direction of two-part geographically deaveraged pricing.

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<sup>33</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.146

<sup>34</sup> ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, August 2009, p.35

- 3.29 The advent of services such as mobile and VoIP has had dramatic effects on the pricing of fixed voice services, in addition to the effect on distribution and level of fixed voice total. These services are increasingly offering a package up a total value of calls on a national basis rather than charging on an individual call basis. For example, Engin offers a basic bundle of unlimited local and national calls with a flat per minute rate to mobiles and international numbers for a flat monthly rate.<sup>35</sup> This leads to less relevance of the price structure for an individual call since any number can be made during a billing period.
- 3.30 Therefore, a wholesale price structure that fails to acknowledge retail pricing structures will hamper access seekers' ability to compete in downstream markets. Indeed, Telstra's ability to impose such an archaic structure on its competitors (and not on itself) has the potential to hinder competition and innovation in the fixed voice service market. This is because access seekers are competing with Telstra on a different cost base for the same inputs.
- 3.31 Indeed, the ACCC's own price benchmarking does not report on price differences by geographic area. Rather, price indices are reported based on the service – local, national, international and to mobile.<sup>36</sup> The ACCC also found that two-part tariffs and geographic pricing were not common in pricing structures in other jurisdictions.<sup>37</sup> Optus has carried out a desktop benchmarking exercise which confirms this finding (the results of which are set out in Appendix C). This is a likely consequence of the fact that such price structures are neither a relevant determinant of costs incurred nor how costs should be efficiently recovered.

*Inconsistent with the NBN – would need to change*

- 3.32 The forthcoming migration to the NBN represents an opportunity for change. In the new environment the current interconnection model with its geographically de-averaged pricing structure is unlikely to survive. The reasons for this were recently explained by Simon Hackett of Internode:

*Telstra (as the dominant fixed line voice carrier) has long imposed onerous, outdated and expensive constraints (both technical and financial) upon other carriers wishing to achieve financially and technical efficient bilateral 'local number portability' (LNP) and the bilateral exchange of voice calls with the Telstra voice network.*

*The importance of this 'voice peering' in the context of the NBN is that the NBN will physically remove the existing distance based cost related to originating and terminating voice calls, and will replace that with free carriage of all calls to NBN customers via Voice over IP...*

*As such, it is logical to expect the replacement of the existing CCS7, distance based, circuit switched PSTN mechanisms (call origination, call termination, and local number portability) with the simple peering of each service provider voice network using Voice over IP.<sup>38</sup>*

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<sup>35</sup> Engin website, *VoIP Phone Plans*, <http://www.engin.com.au/Voip/Voip.aspx>, accessed 18 May 2011

<sup>36</sup> ACCC, *Changes in the prices paid for telecommunications services in Australia 2008-2009*, 1 June 2010

<sup>37</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.147

<sup>38</sup> Hackett, Simon, "Peering Policy Gaps with the National Broadband Network", *Internode Blog (as published in the Telecommunications Journal of Australia, May 2011, Vol 61 N1)*, 16 May 2011

- 3.33 NBN Co will offer a Layer 2 service, which is consistent with it being a 'wholesale only' provider. This means that the PSTN OTA equivalent service will be between access seekers, rather than a service provided by the network owner. Therefore, the peering arrangement which Internode is proposing means that each service provider incurs its own costs of interconnection and does not impose any costs on others for conveying their traffic. This is in stark contrast to the existing arrangements, which as described by Mr Hackett, impose significant costs on access seekers.
- 3.34 It is not yet clear what the interconnection arrangements will be under the NBN but with transparent uniform access prices, and the significant change in the access infrastructure, it is obvious that the continuance of the current geographic de-averaged structure will be untenable.
- 3.35 The ACCC has already had regard to the intended charging approach of NBN Co in setting averaged ULLS prices for Bands 1 through 3. In the Statement of Reasons for the IADs, it stated:
- The ACCC has also had regard to the changing nature of the telecommunications industry and NBN Co's stated intention to charge uniform national wholesale prices for the National Broadband Network (NBN).*<sup>39</sup>
- 3.36 The ACCC considered that the averaging approach would "ease industry's transition to national wholesale pricing for the NBN."<sup>40</sup> Similar statements were made in the Discussion Paper.<sup>41</sup> Consistent with this approach, Optus submits that the ACCC should ease industry's transition to the NBN by adopting a uniform pricing structure for the PSTN OTA service.

## **Option 2: Adopt a single national rate**

- 3.37 Optus submits that the option to replace the existing rate table with a single national rate is the superior approach. This is because it will address many of the flaws with Option 1 and it is more consistent with the LTIE criteria of the Act. Specifically, Option 2 will:
- a) Enable cost recovery to meet the legitimate business interests of Telstra - without reliance on the flawed PIE II model;
  - b) Simplify administration by avoiding the need for frequent revision for changes in traffic patterns;
  - c) Not raise the risk of by-pass since it is reflective of current costs and by-pass is not a real risk for this service;
  - d) Better reflect retail price structures and will thereby promote competition; and
  - e) Facilitate transition to the NBN.
- 3.38 Each of these is discussed in the sections below.

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<sup>39</sup> ACCC, *Interim access determinations for the declared fixed line services: Statement of Reasons*, March 2011, p.15

<sup>40</sup> ACCC, *Interim access determinations for the declared fixed line services: Statement of Reasons*, March 2011, p.15

<sup>41</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, pp.143-144

### Enables cost recovery

- 3.39 The FLSM is a building blocks model that seeks to estimate the costs of Telstra providing its fixed-line services over its existing network (as opposed to the costs associated with a hypothetical network). It uses inputs provided by industry, Telstra and regulated accounts and estimates a revenue requirement for each service. Prices are derived by dividing the revenue requirement for each service by the forecast demand for that service.
- 3.40 Accordingly, the PSTN OTA price that is estimated utilising the FLSM represents the costs expected to be incurred by Telstra in providing the service. It is therefore within the legitimate business interests of Telstra for a single national rate because such a rate will guarantee cost recovery for Telstra. The ACCC summarised this by stating that:

*[t]he FLSM estimates a single national average price for PSTN OTA. The ACCC does not have geographical cost information to enable it to directly estimate the costs of providing PSTN OTA in different geographic areas.<sup>42</sup>*

- 3.41 This point has been made by the ACCC before. In its 2009 review of fixed line pricing principles the ACCC proposed an “all zones” single per minute indicative price. To support the average rate, the ACCC has noted that a single rate would not prevent Telstra from adequately recovering its costs since “they are likely to be the same throughout CAN and/or inter-exchange network”.<sup>43</sup> This is because the assets that are used to provide the PSTN OTA are similarly geographically dispersed as the assets to provide the MTAS, which is averaged.
- 3.42 The ACCC also acknowledged that commercial negotiations are on the basis of an average headline rate.<sup>44</sup> Therefore, a published headline rate acts as a sufficient starting point for these negotiations, as suggested by the ACCC.

### Simplifies administration

- 3.43 A significant advantage of a single rate is that it is simpler than the existing, complex pricing structure. This was also recognised by the ACCC.<sup>45</sup>
- 3.44 The existing rate structure requires access seekers to forecast traffic on a disaggregated basis for business budgeting purposes. In a rapidly changing environment, the accuracy of these forecasts becomes increasingly unreliable which leads to business uncertainty. A single rate reduces the margin of error as only the total minutes require estimation, rather than the locations and number of calls in addition to their duration. The ACCC recognised the simplicity of averaged rates in the context of averaged ULLS prices.<sup>46</sup>
- 3.45 A single national rate will also eliminate the considerable complexity the ACCC would face in determining a robust geographic estimate of PSTN costs on a RAB basis and rolling these

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<sup>42</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.150

<sup>43</sup> ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, August 2009, p.35

<sup>44</sup> ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, August 2009, p.35

<sup>45</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.150

<sup>46</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.143

forward from time to time. The ACCC stated that this would be an additional benefit of a single rate:

*[d]etermining a national average price only would avoid the need to determine a pricing matrix using potentially out-dated (and inaccurate) geographic cost information obtained from the PIE II model.*<sup>47</sup>

3.46 This is because, as described above, a disaggregated rate table would require frequent revision to reflect the market dynamics affecting traffic patterns. Fittingly, the ACCC stated that:

*It would also reduce the regulatory burden on access seekers and Telstra to submit PSTN OTA traffic and call duration information.*<sup>48</sup>

3.47 Indeed, the regulatory and administrative burden imposed on Optus is significant. These, as well as the potential business improvements and savings, are discussed in detail in Appendix D.

### Does not raise the risk of bypass – reflects current costs

3.48 Telstra has argued that there would be “adverse impacts on the LTIE” as a result of averaged PSTN OTA prices. This is said to be as a result of averaged prices sending “incorrect signals about the costs of PSTN OA and TA, especially in non-metro areas as calls that transit longer than the average distances (typically rural) are subsidised by calls over shorter transit links than the average (typically metro).”<sup>49</sup>

3.49 Telstra further states that “wholesale customers will obtain a windfall gain in respect of calls terminating in rural areas, which will be exacerbated by adopting deaveraged prices for ULLS.”<sup>50</sup> This is because Telstra argues that access seekers can bypass its network in metro areas with “cheap” ULLS and then acquire the (lower) TA in rural areas. Telstra’s logic is deeply flawed.

3.50 Firstly, the bypass argument hinges on the incorrect premise that costs differ between geographic areas sufficiently such that an average price would encourage bypass in ‘cheaper’ areas. Optus has shown in the preceding sections that cost differences are unlikely to be large for the PSTN OTA. Therefore, an average price is the best reflection of the structure of the costs, given that they are sunk. This is consistent with the conclusions of the CEG report (Attachment 1).

3.51 Secondly, it is inconceivable that the structure of the PSTN OTA will have any effect on current investment decisions to bypass Telstra’s network. In the quantification of the outcomes of infrastructure investment decisions, the relative differences in cost imposed on access seekers by different structures for the PSTN OTA will be outweighed by other drivers. As indicated earlier in this submission, decisions on DSLAM investment will be determined by the price of the ULLS and by the anticipated timing of the roll-out of the NBN. It is delusional for Telstra to argue that the price of PSTN OTA set at one level or another may cause an access seeker to change their investment decisions and seek to overbuild the Telstra network.

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<sup>47</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.150

<sup>48</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.150

<sup>49</sup> Telstra, *Pricing Principles for Fixed Line Services Response to the ACCC’s Draft Report*, October 2010, p.127

<sup>50</sup> Telstra, *Pricing Principles for Fixed Line Services Response to the ACCC’s Draft Report*, October 2010, p.127

- 3.52 Thirdly, we note that Telstra seems to want a bet each way on the by-pass point. It uses the by-pass argument to attempt to justify both averaged ULLS prices and de-averaged PSTN OTA prices.

### Better reflection of retail pricing

- 3.53 Retail pricing does not reflect the current PSTN OTA pricing structure, as noted in the preceding section. Pricing structures are changing with an increasing trend towards fixed price packages. Under these packages customers pay a fixed monthly fee and receive a certain level of (sometimes an unlimited number of) calls or call minutes. Importantly, these arrangements are breaking the link with individual services and historic ways of per minute or per call charging.

- 3.54 These changes were noted as far back as 2008, when the Glasson Review noted that increased competition in the long-distance calling market had affected the pricing structure:

*the market experience in long distance prices has seen a move away from distance-based charging to single nationwide long distance prices. This appears to have been a product of competition, as different providers sought to differentiate themselves by not only having lower prices for various distances, but also by having larger areas addressed within each price band. This led to the elimination of distance-based charging.<sup>51</sup>*

- 3.55 It is important for wholesale access prices to align with the retail pricing structure; otherwise distortions can arise. A key advantage of a single, average price is that it will promote such consistency. A uniform PSTN OTA price would be consistent with the pricing of mobile telephony. Mobile phone prices are nationally based, such that anticipating the costs of a call (or set of calls) is more straightforward compared to the structure of fixed phones.
- 3.56 Importantly, a single national price also enables competitive providers to compete with Telstra, which holds a dominant position in the fixed-line voice market. Telstra's retail pricing bears no resemblance to the existing PSTN OTA rate table and so competitors which face differential costs must meet Telstra's retail offers whilst facing higher costs in regional and rural areas due to disaggregated access prices. Therefore, rather than a price structure that is reflective of market conditions, the current geographically de-averaged PSTN OTA prices appear to represent a consequence of Telstra's market power to impose differential pricing on its competitors.

### NBN-ready

- 3.57 Optus has shown that the existing rate table is an arcane product of Telstra's monopoly power and no longer reflective of underlying costs nor market conditions. In particular, the interconnection arrangements that it represents are due to the fact that Telstra physically connects over 90% of the voice market to its dedicated network. The NBN poses significant challenges to the relevance of these arrangements.
- 3.58 Firstly, the interconnection arrangements will be delivered as a function of the arrangements of the service provider, which will not necessarily be Telstra. This is because all interconnection will be between access seekers, rather than an arrangement between access seekers and the physical network operator, as it is now.
- 3.59 The physical capabilities of next generation networks (like the NBN) are such that routing need not follow specific pathways. This means that there are many options for interconnection and the delivery of calls. This poses a second challenge – with a dedicated voice network no longer

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<sup>51</sup> Australian Government, *Regional Telecommunications Review Committee Report 2008: Framework for the Future*, September 2008, p.230

in place, the delivery of voice calls will be the product of application layers. The result being that interconnection in the NBN is more likely to resemble those of the internet, rather than fixed voice networks.

- 3.60 Together, these challenges represent a significant opportunity to reform the existing interconnection charging regime, as it would not be appropriate to carry this through to the NBN. A nationally averaged price represents an appropriate transition to otherwise starkly different arrangements. It will encourage access seekers to revise product pricing, as well as the systems and billing arrangements that give effect to the PSTN OTA.



## Section 4. Geographic Exemptions

4.1 In 2007 Telstra applied to have regulation of resale services (WLR, LCS and PSTN OA) rolled back in around 380 CBD and metropolitan exchange service areas (ESAs) where ULLS access seekers were active. As the result of a number of ACCC and Competition Tribunal determinations in 2008 and 2009, by the end of June 2011 there will be 181 deregulated ESAs. The ACCC has proposed to incorporate the effect of these exemption determinations into the FADs.

4.2 In Optus' view the ACCC should not incorporate the exemptions, since to do so will adversely impact on competition by allowing Telstra to raise its wholesale prices without constraint in exempted exchange areas. Moreover, there will be no offsetting benefits, since the exemptions are unlikely to achieve the benefits in the use of and investment in infrastructure which the ACCC anticipates, for the reasons explained below.

### Impact on competition

4.3 The ACCC has stated its preliminary view that "incorporating the effect of the Exemption Determinations into the FADS will promote competition principally in the downstream market for fixed voice services."<sup>52</sup> Optus disagrees with this assessment for a number of reasons:

- (a) the exemptions will allow Telstra to raise prices without constraint in exempted exchanges (indeed, Telstra is already seeking to raise wholesale prices in exemption ESAs);
- (b) there is a lack of alternative suppliers of relevant wholesale products able to place real a real competitive constraint upon Telstra in the wholesale market;
- (c) the ACCC's analysis fails to identify significant sectors of the market which will suffer disproportionate damage to competition, including:
  - (i) the corporate sector;
  - (ii) preselected long distance voice customers; and
  - (iii) consumers located on pair gain systems;
- (d) Finally, in Optus' view the exemptions are unlikely to cause any significant changes in the use of or investment in DSLAM infrastructure (for reasons explained below under the heading "Use of and investment in infrastructure"). This largely precludes the possibility of any positive impact on competition.

4.4 For these reasons the exemptions will harm, rather than enhance, competition. Optus submits that the ACCC should remove the exemptions from its FAD, and make regulated fixed line services available in all geographic areas.

### Exemptions allow Telstra to raise prices without constraint in exempted exchanges

4.5 The ACCC's view that the exemptions will enhance competition depends to a significant extent on its expectation that Telstra would be unable to raise wholesale prices in exempted exchange

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<sup>52</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.242

service areas. In its 2008 Final Decision on Telstra's original resale exemption application, the ACCC stated:

*Increased ULLS-based competition will also stimulate the provision of LCS and WLR from ULLS-based competitors seeking to exploit unused capacity, or to exploit potential economies of scale, on their ULLS-based networks. This will provide increased competitive tension at the wholesale level and **constrain Telstra's ability to price its LCS and WLR services at supra-competitive levels** in ESAs in respect of which exemption is granted.<sup>53</sup> [emphasis added]*

4.6 This expectation has not been borne out in practice. Telstra is already seeking to raise wholesale prices in exempted areas. It has been reported publicly that Telstra has sought to raise wholesale prices in exempted areas to access seekers:

*So the ACCC has come out with their first round of price determinations, and what Telstra has said to access seekers is 'you can have the determined prices only in the regulated exchanges, and in the other exchanges we will give you this higher price.'<sup>54</sup>*

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<sup>53</sup> ACCC, Final Decision and Class Exemption, Telstra's local carriage service and wholesale line rental exemption applications, August 2008, p.6

<sup>54</sup> Wilton, Petroc, "CCC blasts Telstra for price hikes at 200+ exchanges", *Communications Day*, 9 May 2011

### Lack of alternative suppliers of relevant wholesale products

- 4.10 The ACCC's position on exemptions depends on the view that ULLS-based competitors to Telstra will be alternative suppliers of wholesale fixed voice services (WLR, PSTN OA) in the exempted exchanges. For example, it states:

*Increased ULLS-based competition will also stimulate the provision of LCS and WLR from ULLS-based competitors seeking to exploit unused capacity, or to exploit potential economies of scale, on their ULLS-based networks.*<sup>55</sup>

*Some, if not all, of the ULLS-based competitors in each ESA will already be supplying a fixed voice service. Therefore, in the majority of the affected ESAs, competitively priced alternative WLR/LCS-type services are likely to be available in the event of a price rise by Telstra ...*<sup>56</sup>

*The ACCC also considers that access seekers will be able to acquire a fixed voice bundle from Telstra **or another supplier** at a commercially negotiated price in exempt ESAs.*<sup>57</sup>  
[emphasis added]

- 4.11 However, the ACCC acknowledges the lack of evidence for this view, noting that it "is not aware of any of any alternative suppliers of the WLR service in the exempt footprint".<sup>58</sup>
- 4.12 Optus acknowledges that there are a number of ULLS-based competitors to Telstra which are active in the exempt exchanges. However, just because a ULLS-based operator is present in an exchange, it does not necessarily mean that ULLS-based operator is able to supply a WLR service which is substitutable for Telstra's product. The 'real world' example provided below illustrates this point.
- 4.13 CiC
- 4.14 CiC
- 4.15 CiC

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<sup>55</sup> ACCC, *Telstra's local carriage service and wholesale line rental exemption applications*, Final Decision and Class Exemption, August 2008, p.6

<sup>56</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.237

<sup>57</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.243

<sup>58</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.219

4.16 CiC

4.17 CiC

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4.19 CiC

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- 4.21 The above example goes some way towards illustrating the reasons why ULLS-based competitors have been unable to exert a competitive constraint upon Telstra in exempt exchanges. It also assists in explaining why Telstra's freedom to act without constraint is greater in respect of business customers compared to residential customers (although further reasons are noted in the next section).
- 4.22 A further reason why ULLS-based operators have in practise been unable to effectively constrain Telstra's pricing in wholesale markets is because Telstra is able to leverage its market power in non-exemption geographic areas to reduce competition inside exemption ESAs.
- 4.23 An example of how this occurs is provided by Telstra's conduct with regard to wholesale broadband services. **CiC**
- 4.24 **CiC**
- 4.25 **CiC**
- 4.26 Through the conduct described above, Telstra is able to leverage its market power in non-competitive geographic areas to reduce competition inside exemption ESAs. As a result, Optus and other wholesale providers are unable to constrain Telstra's pricing of wholesale services in the exemption footprint.

#### Corporate market

- 4.27 The ACCC's market definition omits to define an important market in which purchasers of the relevant services have very different requirements from the mass market.
- 4.28 Large business and government end-users typically require different grades of functionality than residential customers. One of the business grade functionalities is "complex services" including:
- (a) analogue NT 1 (PSNT services provided using ISDN infrastructure with Analogue NT1;
  - (b) ISDN;
  - (c) call diversion number only;
  - (d) virtual private networks;
  - (e) line hunt;
  - (f) fax duet (two service numbers on a single line, the second for a fax, so there is no need for two line rentals);
  - (g) payphones;
  - (h) securitel (security alarm monitoring service); and
  - (i) huntgroups.<sup>59</sup>

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<sup>59</sup> Telstra wholesale ULL Complex Products

- 4.29 Complex services including fax duet, huntgroups, voicemail on huntgroup and line hunt are some of the typical features often required by Optus' corporate and government customers. Optus is able to offer the majority of these features using its 'Optus Evolve' IP-based VPN platform and the associated suite of products, which are delivered via Ethernet access infrastructure or the ULLS. **CiC** Optus has previously made submissions to the ACCC about complex services. Optus refers and relies on its submission to the ACCC on Telstra's PSTN OA Service Exemption Application, December 2007, submission in response to the ACCC's Draft Decision on PSTN OA exemptions, September 2009, submission in response to the ACCC's Draft Decision on Telstra's LCS and WLR Exemption Applications, June 2008 and its letter to the ACCC on 10 January 2008 regarding the impact of WLR/LCS Exemptions in the Corporate and Government Market Segment.
- 4.30 Another important feature required by large business and government end-users is the ability to procure service on a 'whole of business' basis, since these customers often have customer sites located at different geographic locations. **CiC**
- 4.31 Further, large business and government end-users prefer to deal with a single supplier for reasons of simplicity and convenience. It is less costly to manage than to have multiple contracts, it allows simple cost reconciliations that enables costs to be allocated to the customers cost centres, lower tariff benefits (intra-fleet vs. inter-fleet calls), and the ease and convenience of a single help desk. Optus has previously submitted to the ACCC the importance of having a 'whole of business' deal for large business and government customers. Optus refers and relies on its submission to the ACCC on Telstra's PSTN OA Service Exemption Application, December 2007, submission in response to the ACCC's Draft Decision on PSTN OA exemptions, September 2009, submission in response to the ACCC's Draft Decision on Telstra's LCS and WLR Exemption Applications, June 2008 and its letter to the ACCC on 10 January 2008 regarding the impact of WLR/LCS Exemptions in the Corporate and Government Market Segments.

- 4.32 **CiC**
- 4.33 **CiC**
- 4.34 This discussion should assist in explaining why Telstra's freedom to act without constraint is greater in respect of business customers compared to residential customers. **CiC**
- 4.35 In summary, incorporation of the exemptions in the FADs will damage competition, particularly in the corporate space.

Long distance preselect market

- 4.36 The removal of regulated access to PSTN OA service would be likely to impact on competition in long distance (LD) services. This is because Telstra would have the ability and incentive to reduce competitors' ability to compete in that market and thus competition in the LD services generally would be diminished.
- 4.37 The declaration of PSTN OA has enabled the provision of LD, IDD and FTM services to be unbundled from network access and local call services. As a result, an end-user may elect to obtain LD, IDD and FTM services from a particular service provider while obtaining network access and local call services from a different provider (such as Telstra). This may be achieved through the end-user preselecting a pre-selection provider for the purpose of all LD, IDD and FTM calls, or through the end-user dialling an override code for the purposes of making particular LD, IDD or FTM calls via the override provider.
- 4.38 For example, Optus participates in the standalone market as a wholesaler of switching and carriage services, in addition to PSTN OA (but not WLR or LCS), to a number of service providers who provide pure pre-selection and/or override services to end-users. Some such service providers operate entirely on a resale basis without using switching or transmission infrastructure of their own. Optus also acquires the PSTN OA for re-supply as an input, together with limited transmission and call termination services over the Optus network, to service providers who own limited network infrastructure and switches.
- 4.39 Note that in the context of the standalone market for LD services, the relevant bottleneck infrastructure is the individual customer's line. Likewise the real geographic limit of the relevant market is the individual customer's line –not the ESA. That is (putting aside for the moment competition in bundled services) provided an end user continues to purchase line rental services from Telstra, only Telstra can offer LD services with respect to that customer. Substitution to another provider with respect to LD services alone is only made possible through the PSTN OA declaration. And only Telstra can offer wholesale PSTN OA services with respect to that customer. Optus has previously made submissions regarding the impact of geographic exemptions in the LD market. Optus refers and relies on its submission to the ACCC on Telstra's PSTN OA Service Exemption Application, December 2007 and submission in response to the ACCC's Draft Decision on PSTN OA exemptions, September 2009

- 4.40 The exemptions have already caused damage to competition in the long distance preselect market. **CiC** Incorporation of the exemptions in the FADs will only further extend and make permanent that harm to competition.

#### Pair gain systems

- 4.41 Approximately seven per cent of SIOs within the ACCC's exemption footprint are unavailable for ULLS use by access seekers due to deployment of pair gain systems, as the ACCC has recognised. Given that the purpose of the exemptions is to promote ULLS-based competition, it is difficult to see how application of the exemptions in areas affected by pair gain systems can have any impact other than to weaken competition by Telstra's competitors.

- 4.42 The ACCC states that it has "dealt with the issue of lines affected by pair gain technology by excluding those lines from the calculation of the total number of 'addressable SIOs' within an ESA." The ACCC appears to consider that the pair gain issue will not have a significant competitive impact at the geographic level of ESAs. For example, it states:

*The ACCC had considered in its 2008 exemption orders that the presence of three ULLS based competitors was sufficient to ensure sufficient competition in the long run (notwithstanding the presence of a percentage of lines affected by pair gains within those ESAs). The ACCC does not consider that the presence of pair-gain systems in the ESAs will significantly impact competitor presence in the ESAs which become exempt ESAs.<sup>60</sup>*

- 4.43 Optus submits that the "presence" of ULLS-based competitors *in an exchange area* is manifestly incapable of ensuring "sufficient competition" in respect of services delivered to the 7% of SIOs which are unable to be supplied by ULLS-based competitors. The ACCC's statements serve only to highlight the inadequacy of any attempt to analyse the competitive impact of the pair gain issue at the geographic level of ESAs. To a home or business owner, the fact that a competitor to Telstra may be offering relevant services in the next street over is simply irrelevant. The additional cost of an uncompetitive telephone service is unlikely to provide sufficient reason to move house. The ACCC's decision to continue the exemptions would leave these customers to the tender mercies of an unconstrained monopoly supplier.
- 4.44 Optus submits that – if the exemptions were to be incorporated – the sensible response to this issue would be to establish a new a limitation in the exemption orders to limit the exemption from applying to those lines affected by the presence of a pair gain system.
- 4.45 However, as the ACCC notes, Telstra has opposed such a limitation on the grounds that it would be "complex, costly and impracticable".
- 4.46 Optus submits that the ACCC should not accept Telstra's submission in respect of this point, which is self-serving and which makes no attempt to address balance the claimed costs against the very real competitive detriment which would otherwise be caused. Without such a condition, the exemption orders sought would have the effect of creating a sizeable class of end-users in the Metro ESAs who could not be serviced by means of any regulated services and in respect of whom Telstra would be restored as the monopoly provider.

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<sup>60</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p. 240.



- 4.47 In summary, Optus submits that Telstra's conduct to date with regard to pricing of resale services in exempted ESAs is only a foretaste of the conduct it is likely to display once the exemptions are 'locked in', given the lack of competitive constraints noted above. Accordingly, incorporation of the exemptions in the FADs will damage competition.

#### **Use of and investment in infrastructure**

- 4.48 A key reason noted by the ACCC in support of incorporating the exemptions into its FADs is its expectation that the exemptions will produce benefits with regard to the use of and investment in infrastructure. In particular, the ACCC notes:

*By effectively deregulating the WLR, LCS and PSTN OA services within the ESAs, the Exemption Determinations encourage access seekers to utilise existing DSLAM infrastructure to provide ULLS-based voice services, and invest in new DSLAM infrastructure where it is efficient to do so.<sup>61</sup>*

- 4.49 In Optus' view the exemptions are unlikely to achieve the benefits expected by the ACCC. In fact the exemptions are unlikely to cause any significant changes in either the use of or investment in DSLAM infrastructure.

#### Investment in infrastructure

- 4.50 The ACCC's view that the exemptions will encourage efficient investment rests upon the assumption that by removing the option of a regulated resale service (WLR and PSTN OA), the exemptions will encourage access seekers to invest in new DSLAM infrastructure.
- 4.51 However, Optus submits that the removal of access to regulated resale services is not a significant driver of investment in DSLAM infrastructure. Decisions on customer access and investment are driven by other factors.
- 4.52 Optus, for example, does not rely on resale services. In fact, Optus' Consumer and SMB units ceased offering resale-based services to new customers in 2007 for reasons unrelated to the exemptions.<sup>62</sup> It follows that the geographic exemptions which took effect in 2011 and removed the option of a regulated resale service are unlikely to have had any impact on the decisions taken by Optus, and in particular have neither encouraged DSLAM investment nor discouraged use of resale. **CiC** In summary, for Optus the DSLAM investment decision is not highly sensitive to the availability of regulated resale services.

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<sup>61</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.242

<sup>62</sup> **CiC**

4.53 A more important driver of DSLAM investment decisions is the imminent construction of the NBN. The NBN affects the investment decision by reducing the time period in which operators can receive positive cashflows from any investment in DSLAMs. It thereby makes the economics of DSLAM investment less appealing (at current ULLS price levels). Optus' recent customer access decisions are illustrative. **CiC**

4.54 The ACCC notes the potential impact of the NBN construction on the recovery of investment costs in its paper, but dismisses the impact, based in part upon evidence of recent DSLAM construction by access seekers:

*The ACCC observes that these previous announcements regarding an NBN build do not appear to have discouraged investment in DSLAM/MSAN infrastructure. ...*

*These instances of DSLAM investment support the ACCC's view that, despite uncertainty surrounding the NBN, access seekers will continue to invest in DSLAM/MSAN equipment where they consider it efficient to do so.<sup>63</sup>*

4.55 Optus notes, however, that the "instances of DSLAM investment" to which the ACCC refers has already taken place. Those "instances" are not relevant to the question at hand, which is whether incorporating the exemptions in the FADs will encourage efficient investment *in the future*.

4.56 The imminent construction of the NBN affects access seekers' investment decisions by reducing the time period in which they can receive positive cashflows from any investment in DSLAMs. All other things equal, that time period will be shorter (given the impending NBN construction), the later in time is the contemplated investment. For any given exchange area, the NBN makes the economics of DSLAM investment less appealing now than it was in 2010, or at the beginning of 2011.

4.57 The ACCC notes its view of the time remaining before cutover to the NBN occurs:

*The construction of the NBN is likely to be completed by 2020. If the fibre roll-out will not affect an ESA until the later stages of the NBN roll-out, the NBN will not be likely to impact significantly upon the ability of an efficient access seeker to recoup DSLAM investments in the 380 Attachment A ESAs.<sup>64</sup>*

4.58 However, there is significant uncertainty around the timing of the NBN roll-out, so access seekers cannot be certain that the fibre roll-out will not affect an ESA until the later stages of the NBN roll-out. Certainly it would be unrealistic to assume that any given ESA will not be affected until the completion of the NBN in 2020.

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<sup>63</sup> Public inquiry to make final access determinations for the declared fixed line services, Discussion paper, April 2011, p.236

<sup>64</sup> ACCC, Public inquiry to make final access determinations for the declared fixed line services, Discussion Paper, April 2011, p.238

- 4.59 The ACCC states that the time required to make a return on a DSLAM investment is within two years of deployment. However, this timeframe depends upon the ACCC's expressed view that the fixed costs of DSLAM infrastructure are in the order of \$12,000-\$14,000 per DSLAM:

*The most recent information before the ACCC (obtained by the ACCC for the purpose of the 2008 exemption applications), suggests that the fixed costs of the DSLAM/MSAN infrastructure are in the order of \$12,000-\$14,000 per DSLAM. This includes the DSLAM/MSAN sub-rack and racks, the DSLAM itself, alarm and power distribution units, power cabling to the racks, and signal and cabling to the racks.<sup>65</sup>*

- 4.60 Optus submits that the ACCC's estimate does not take into account a number of key cost drivers relevant to total DSLAM investment costs. **CiC** As a result, the ACCC is likely to have significantly under-estimated total DSLAM investment costs. Consequently, the ACCC's view of the time required to make a return on a DSLAM investment is likely to be unreliable.
- 4.61 Moreover, if a carrier was to make the decision to invest in new DSLAM infrastructure, it would not begin earning revenue immediately. Telecommunications networks are capital intensive and the lead time for DSLAM investment is necessarily very long. **CiC**
- 4.62 Given these matters, significant further DSLAM investment appears unlikely at current ULLS price levels. The factors which impact the DSLAM investment decision are ULLS access prices, the significant costs of new infrastructure, the long lead times for new investment and the impending construction of the NBN. Compared to these matters, Optus submits that any stimulatory impact of the exemptions would be absolutely minimal.
- 4.63 Moreover, this issue is also of relevance to the expiry date of the exemptions. If the ACCC decides to incorporate the exemptions, it should recognise that even if there was any positive impact at all flowing from the exemptions, that impact would have diminishing relevance as the NBN construction timetable progressed. This suggests that if the ACCC decides to incorporate the exemptions, it should retain the current 2014 expiry dates, rather than extend until 30 June 2016.

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<sup>65</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.234

## *Efficiency of investment*

- 4.64 In support of its view that any investment stimulated by the exemptions would be efficient, the ACCC states that:

*... This is because, where necessary, the move to ULLS-based provision of fixed voice services prior to a fibre upgrade will allow access seekers to build their reputation and customer base through the ability to provide differentiated products. The ACCC considers that this will allow access seekers to better transition to an alternative service and make it more viable to compete in downstream markets when fibre is deployed.<sup>66</sup>*

- 4.65 Optus considers that the “reputation and customer base” effects noted by the ACCC are likely to be of lower relative magnitude compared to other efficiency effects, in particular the losses in productive efficiency caused by substantial duplication of infrastructure. The ACCC notes that in the current exempt ESAs, there are on average 5.4 ULLS-based competitors (excluding Telstra). Optus questions the efficiency of any further duplication of DSLAM infrastructure in these exchanges.

## Use of infrastructure

- 4.66 In support of its view that incorporating the exemptions will encourage access seekers to utilise existing DSLAM infrastructure to provide ULLS-based voice services, the ACCC notes that access seekers have continued to invest in additional spare ULLS capacity since the original exemption determinations, and that there is a consistent trend of increasing ULLS SIOs within the 380 Attachment A ESAs.
- 4.67 However, the ACCC does not appear to have found evidence that these increases were caused by the exemptions. Access seekers with existing DSLAMs already have an incentive to transfer their resale customers to ULLS, given that ULLS access charges are lower than WLR charges and the DSLAM investment expense is a sunk cost.
- 4.68 Optus submits that increases in ULLS capacity and ULLS SIOs are part of a broader trend of increase in ULLS-based competition which was already apparent before the exemption determinations and which has continued since, unaffected by the exemption determinations themselves.

## **Adjustments required**

### ESAs where Telstra has announced that it will cease to provide the ULLS

- 4.69 If the ACCC decides to incorporate the exemptions into its FADs, Optus considers that it should make an adjustment to the limitation that *“the exemption ceases to apply within an ESA from the date which Telstra first ceases to be an access provider of the ULLS within the relevant ESA”*.<sup>67</sup>
- 4.70 This limitation is not strong enough because it does not adequately preserve access options in circumstances where Telstra has announced that it will cease to be an access provider of the ULLS within the relevant ESA at a certain future date.

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<sup>66</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.237

<sup>67</sup> Australian Competition Tribunal, *Order under paragraph 152AW(1)(b) exempting Telstra from standard access obligations in respect of the LCS File No. 2 of 2008*, 24 August 2009, p.11

4.71 The current situation in South Brisbane provides an example. South Brisbane is currently an exempted ESA, notwithstanding that Telstra made an announcement on 30 July 2010 that it plans to decommission its copper network in the South Brisbane exchange. Since access seekers still have DSLAMs installed in the South Brisbane exchange and Telstra is still an access provider of ULLS, under the current rules South Brisbane will remain an exempted ESA until the date Telstra decommissions its network. **CiC**

4.72 **CiC**

4.73 **CiC**

4.74 **CiC**

4.75 Optus submits that South Brisbane should be removed from the exempt list. Similarly, the exemptions should cease to apply in respect of any exchange from the date Telstra announces a “network upgrade”. Any exchange where a future upgrade is announced requires an alternative access method immediately. If the ACCC decides to incorporate the exemptions into its FADs, it should amend the limitation to the following:

*the exemption ceases to apply within an ESA from the date which Telstra first announces that it will cease to be an access provider of the ULLS within the relevant ESA at a certain future date.*

#### Reporting requirements

4.76 In the event the ACCC decides to incorporate the exemption into the FAD, Optus supports the ACCC’s proposal to revise the reporting requirements so that access seekers no longer have to report on the ‘Number of installed DSLAMs’.

## Section 5. Efficiency Mechanism and Length of Regulatory Period

- 5.1 For the purposes of determining the levels of capital expenditure and operating expenditure to be recovered through access prices, the ACCC has proposed to set prices based upon forecast levels of expenditure, as opposed to the costs which Telstra actually incurs. Specifically, the ACCC has proposed to adopt an efficiency benefit sharing scheme (EBSS) similar to the schemes used by the Australian Energy Regulator (AER) in electricity regulation. This proposal is based upon the ACCC's view that this arrangement will generate incentives which will encourage Telstra to incur costs efficiently.
- 5.2 Below Optus argues that the fundamental reasoning behind the ACCC's implementation of an efficiency mechanism is misplaced. The reasons which justify such a policy in the energy sector do not apply in telecommunications; consequently the expected efficiency benefits will not materialise. Rather, the scheme will provide Telstra with both the incentive and the means to inflate its forecasts and recoup revenue substantially greater than its actual expenditure.
- 5.3 In this section Optus will propose an alternative approach to ensure that access prices reflect efficient costs actually incurred. For similar reasons Optus will advocate that the ACCC should adopt a three year regulatory period, rather than the proposed five years.

### Efficiency mechanism

#### The ACCC's proposal to include a carry-over is misguided

- 5.4 The ACCC has stated its view that efficiency incentives will promote efficient expenditure by Telstra.<sup>68</sup> Whilst Optus agrees that it is important to ensure adequate incentives are in place, we do not support the adoption of an efficiency mechanism as part of the regulatory regime because we consider that adequate incentives already exist. Therefore, any additional mechanism to address a non-existent problem is misguided and will result in unnecessary costs and risks which are not offset by any benefits.
- 5.5 For over a decade Telstra has been subject to a type of regulatory model – TSLRIC – which distinctly decouples actual expenditures from access prices. Under that regime, any deviations between the actual costs and forecasts were retained by Telstra, similar to an efficiency mechanism but never passed on to end-users (unless they happened to be Telstra shareholders).<sup>69</sup> As a result, it can be assumed that Telstra had significant incentives to minimise costs under such a framework, in order to retain the difference. It is therefore likely that Telstra's historic and current cost expenditure has been efficient.
- 5.6 The move from TSLRIC to a building block model (BBM) approach was specifically intended to address the decoupling of prices from actual costs. However, because the introduction of a BBM will link revenues to costs, the ACCC appears to be concerned that the reform might bring about a weakening of Telstra's incentives to minimise cost.
- 5.7 Efficiency mechanisms are an integral part of some regulatory regimes as a way to provide incentives to minimise costs when the regulated business does not face external pressures to

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<sup>68</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p. 82

<sup>69</sup> However, contrary to the ACCC's expectations, the TSLRIC regime resulted in ever increasing modelled costs that were unrelated to Telstra's actual incurred network costs.

reduce costs. Notably, they were introduced as a distinct way to address a well-documented problem of overspending in regulated utilities. Today, they are an ubiquitous part of the regulatory 'package' in the energy and water sectors. The ACCC appears to consider that the same reasoning will carry over to the telecommunications sector, and that a similar efficiency mechanism will also be appropriate here.

- 5.8 Crucially, however, Telstra differs from regulated utilities in the water and energy sectors in terms of its existing incentives. Regulated energy and water utilities do not face external pressures to reduce costs because they are compensated for close to 90% of their costs through regulated tariffs because the companies are essentially 'lines only' businesses (that is, no retail functions). For Telstra, by contrast, only a small proportion (**CiC**)<sup>70</sup> of its revenue is received from regulated sources; therefore Telstra is compensated for only a small proportion of its costs through regulated tariffs. Hence Telstra does not receive any cost-reflective compensation for the bulk **CiC** of its costs. Telstra must recover those costs through its retail prices, which are unrelated to cost. Telstra's duty to its shareholders requires it to maximise its profits so it faces strong external pressures to reduce costs (given that the bulk of costs will not be linked in any way to revenue). It therefore faces extremely high-powered incentives to minimise cost *already*.
- 5.9 Although the introduction of a building block model will link some revenues to costs, the fact that the link applies to such a small proportion (**CiC**) of those costs means that the BBM is unlikely to bring about any weakening of Telstra's incentives to minimise cost. This is because the vast bulk of costs are network-related and common to both retail and wholesale services. Therefore (with respect to such common costs) Telstra will be unable to become lax in its cost controls on the wholesale side without simultaneously becoming lax in controlling its retail-related costs – which it faces strong external pressures to reduce, as noted above.
- 5.10 Optus considers that it is highly unlikely that further efficiency gains can be made. Efficiency mechanisms aim to provide incentives for service providers to reduce costs and increase productivity with given demand conditions. That is, to achieve cost savings without any expected changes in demand. Therefore, the target is to improve the way activities are carried out without the number being affected. The major productivity savings realised in the energy sector that occurred following corporatisation and privatisation (which coincided with the introduction of incentive regulation) were these sorts of savings; for example, implementing automation into provisioning and billing, relying on less personnel for call-outs, more efficient scheduling and managing 'downtime' by contracting out for infrequent activities. It would appear that many of the available productivity improvements, such as those described above, have been exhausted, given that it is likely that Telstra's expenditure is already on an efficient path. This means that it is unlikely that significant further productivity improvements or 'efficiencies' can be made.
- 5.11 Moreover, Telstra faces other considerable commercial incentives to minimise future expenditure, as Optus has previously submitted.<sup>71</sup> Briefly, these are:
- a) *Declining demand* - the recent steep decline in demand for fixed line services was far more rapid than expected, indicating that forecasts may be less reliable for setting prices than previously or in other industries. Therefore, in order to maintain margins, Telstra will need to adjust prices and/or costs for the change in volume. Depending

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<sup>70</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p. 122

<sup>71</sup> Optus, *Submission to Australian Competition and Consumer Commission in response to the Draft Report Telecommunications Access Pricing Principles for Fixed Line Services*, October 2010, pp. 16-19

on the relationship between demand changes and the length between price changes Telstra will be forced to cut costs to meet publicised earnings guidance; and

- b) *Agreement with NBN Co* - with expectations to migrate its fixed line customers and lease its ducts and pipes eventually to another party, Telstra has an incentive to defer capital and operating expenditure in order to maximise the return from the transaction.<sup>72</sup> It is common practice for a firm to minimise expenditure on a soon to be retired asset ('sweat the asset') in order to maximise its return. This is consistent with public statements made by Telstra in relation to declining expenditure on its copper network.<sup>73</sup>

5.12 Given these 'facts on the ground', Telstra faces strong incentives to minimise costs incurred which the introduction of a BBM will not undermine. Further incremental efficiency gains are likely to be difficult to achieve. It follows that allowing Telstra to recover forecast expenditure (rather than actual) is completely unnecessary, and the proposed efficiency mechanism will achieve zero incremental efficiency gains.

5.13 However, the adoption of an efficiency carry-over mechanism will create an incentive for Telstra to deliberately inflate its forecasts, to the detriment of access seekers and end users.

#### *An efficiency carry-over scheme will have significant costs*

5.14 Since an efficiency mechanism gives the prospect of financial gain in order to lower prices for end-users, it is also open to opportunism or 'gaming'. This is because the mechanism provides an opportunity for financial gain if the forecast is higher than actual expenditure, provided prices and volumes received are consistent with the forecast. As a consequence, Telstra has an incentive to overstate its forecast expenditure to ensure that it can 'beat the forecast' and gain from the implementation of an efficiency mechanism.

5.15 As noted above, it is unlikely that Telstra can make significant further productivity improvements or 'efficiencies'. The implication is that any apparent 'efficiencies' will not be real. If Telstra can convince the ACCC that its costs are higher than Telstra believes it will actually incur, then it will financially gain from the mechanism by keeping the difference.

5.16 Unfortunately, this scenario is not at all far-fetched. The key reason that underpins the opportunity for gaming is asymmetric information. Telstra, as the provider of the services, possesses far greater information about the likely costs of managing its network compared to the ACCC. Therefore, it becomes difficult for the ACCC to adequately question Telstra's forecasts or identify whether they are overstated.

5.17 The ACCC has recognised that Telstra has an incentive to overstate its forecasts. To address the incentive for Telstra to overstate its forecast expenditures, the ACCC stated that it will mitigate the incentive by requiring Telstra to:

- a) *Provide a detailed explanation of the information, assumptions and cost drivers used to develop its forecasts for the coming regulatory period – and subjecting this explanation to scrutiny during the consultation process for the price reset; and*

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<sup>72</sup> Telstra CEO David Thodey stated that "*capex responsibility for the fixed network moves somewhere else in an NBN world – should that happen.*" Wilton, Petroc, "Thodey talks new alliance, capex cuts: but steers clear of politics", *Communications Day*, 10 October 2010.

<sup>73</sup> Telstra CFO John Stanhope stated that "*we have factored in some lower CAPEX on the CAN, but as you probably know, we're not spending a lot of money on the copper network now.*" Telstra, NBN conference call transcript, 21 June 2010.



b) *Explain any significant differences between its forecasts for the previous regulatory period and its actual capital expenditure over the period.*<sup>74</sup>

5.18 There are a number of additional pieces of information the ACCC states will be required of Telstra in 'future price resets' to assess the prudence and efficiency of expenditure forecasts. Notably, a key factor in addressing such opportunism is not included, which is time. The losses associated with such information asymmetries could be acceptable if, over a number of reviews, the regulator was able to identify and enforce genuine cost savings. Through the regulator 'getting to know' the business and gaining knowledge of the industry through expert review or retaining staff with specific and relevant expertise, the regulator becomes a better judge of expenditure claims.

5.19 However, with the imminent migration to the NBN, it is unlikely that the regulator will go through enough reviews to gain this knowledge. Given the fact that there will not be a large number of reviews (particularly with the proposed 5 year regulatory period) it does not seem likely that the ACCC will be able to identify if Telstra has overstated its costs or to accurately predict the potential for cost savings.

5.20 Given that there are no significant gains to be made, and much potentially to lose, Optus submits that the proposed adoption of an efficiency mechanism is conclusively not in the interests of end-users. Consequently, the ACCC should eliminate the proposed mechanism. Proceeding without an efficiency mechanism would still allow Telstra to recover its actual costs, which is in its legitimate business interests. Further, without such a mechanism, access prices will be more closely aligned with actual costs, which was a key reason for the reform of the previous TSLRIC regime and its replacement with a BBM. This is undoubtedly in the interests of promoting competition.

5.21 However, should the ACCC continue with its proposed approach, Optus is concerned about the lack of detail surrounding the implementation of an efficiency mechanism. Optus submits that if the ACCC proceeds in its intention to adopt an efficiency mechanism, it must consult carefully on the parameters of such a mechanism. For example, the AER conducted a separate consultation over a period of over 6 months to establish their EBSS for electricity distribution. There was a separate, earlier (and longer) consultation for electricity transmission. Given that the ACCC has indicated that the mechanism would be similar to the AER's, an extensive consultation is likely not required. The ACCC should aim to ensure the specific operation of its proposed mechanism is well understood by industry. It would be appropriate for the ACCC to consult on the parameters in conjunction with the BBM RKR so the requirements for an efficiency mechanism are included.

5.22 Likewise, the ACCC should consider the interaction between Telstra's adverse incentives to overstate its forecasts with the ACCC's ability to establish a robust forecast of expenditures. Importantly, the ACCC has recognised that:

*[f]or an efficiency benefit sharing scheme of this nature to work effectively, it is important that the capital expenditure forecasts used in the FLSM represent an efficient level of expenditure.*<sup>75</sup>

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<sup>74</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 82

<sup>75</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 82

5.23 The ACCC has struggled to obtain the information necessary to carry-out an assessment approach consistent with its stated framework (as Optus demonstrates in the section of this submission which deals with capex and opex forecasts). This raises substantial risks that the costs of an efficiency mechanism will be higher than the alternative approach to account for deviations, which Optus proposes below.

*Optus' proposed approach to ensure access prices are reflective of efficient costs*

5.24 Optus has submitted that Telstra has previously, and continues to, face incentives to minimise its actual expenditure. The significant risk of an efficiency mechanism in these circumstances is underpinned by the reality that it will always be open to a service provider to inflate its forecast costs given that these are yet to be incurred, whereas it is much more difficult to disassemble with respect to costs actually incurred. The ACCC should therefore focus on tying access prices as close as practicable to efficiently incurred costs, and ensuring that reported incurred costs are efficient.

5.25 A first step would be to shorten the length of the regulatory period to no more than 3 years. The advantages of a shorter regulatory period are described in the following section.

5.26 The second step would be to implement a review process at each price reset whereby the ACCC:

- (a) determines the magnitude of the deviation between actual and forecast expenditure; and
- (b) makes an adjustment to the regulated revenue requirement for the next period which cancels out the over-recovery.

5.27 A review process accounts for all deviations between actual expenditures and the approved forecasts and takes them into account in setting the next period's access prices. This means that if actual expenditures are lower (higher) than the approved revenue requirement for the next period will be lower (higher) by the same amount. Effectively, if Telstra inflates its forecasts, it will 'refund the difference' to access seekers through the next period's pricing.

5.28 However, to simplify the review process during each review, Optus proposes that the ACCC account for only material deviations from the forecast for the next pricing period. That is, a 'deadband' or 'threshold' be established around the forecast of say 2% such that deviations within that are retained/borne by Telstra and only when deviations fall outside of the predetermined band are they taken into account for the next price reset.

5.29 The advantage of such an approach is that material changes will be reflected in prices but immaterial ones will not, thereby reducing administration costs and preserving some of the incentives that the ACCC wishes to include with an efficiency mechanism.

5.30 A concern over a regime that seeks to closely align costs with prices is that if a business is able to reduce costs it will have an incentive to 'spend anyway' such that the reductions are not 'clawed back' in the next review. Optus believes that the circumstances surrounding Telstra are such that this should not be a significant problem. That is, given that Telstra has considerable incentives to minimise costs anyway (for the reasons set out above) any unnecessary spending is unlikely. Therefore, any 'fruitless' spending toward the end of a period to meet the forecast is likely to be minimal and so the inclusion of a deadband will protect against such activity.

- 5.31 The table below illustrates how a review with a ‘deadband’ would operate, assuming a 3 year regulatory period. The first set of columns (‘regulatory period 1’) shows a forecast for each year of the period and an actual expenditure amount. The second set of columns (‘regulatory period 2’) shows the forecast for the second period based on the outcomes of the first period.

**Table 1: Illustration of Expenditure Deadband**

	Regulatory Period 1			Regulatory Period 2		
	1	2	3	1	2	3
Year						
Forecast	106	100	100	99	99	99
Actual	100	101	99			
Difference (%)	6 (6%)	1 (1%)	1 (1%)			
Over/under	- 6	n.a.	n.a.			
Adjustment to regulated revenue requirement				- 6		

- 5.32 The row labelled ‘under/over’ accounts for material deviations that will be taken into account in the next period. It can be seen that deviations under 2% do not record a value in that row. In year one, however, it is assumed that the access provider inflates its forecast by 6%, so there is one value in the ‘under/over’ account.
- 5.33 When it comes time to set the forecast for the next regulatory period, the actual expenditure for the previous year will be taken into account (99 in this case). In this example, the forecast has been set based on the last year of actual<sup>76</sup> (at 99).
- 5.34 Further, the value in the ‘under/over’ account is taken into account through an adjustment to the regulated revenue requirement for the next regulatory period. That is, the regulated revenue requirement for period 2 is reduced by 6 (so access prices will be reduced to reflect this). This accounts for the deviation between actual expenditure and the approved forecast and ensures that Telstra receives compensation only for the actually incurred costs in year 1 (100) rather than the inflated forecast value (106).

### Length of the regulatory period

- 5.35 The ACCC has proposed a five year regulatory period primarily to:

*provide certainty during the transition to the NBN. The five-year regulatory period will provide all industry participants with certainty regarding fixed line prices during the initial transition to the NBN. This price certainty will help access seekers in their planning of their own transitions to the NBN.<sup>77</sup>*

<sup>76</sup> Realistically, this may be based on 6 months of data or even the previous year’s account, depending on the timing of review.

<sup>77</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 36

- 5.36 In making this decision, Optus submits that the ACCC is placing certainty over the *existence* of the price over the *substance* of the price. The ACCC has been unable to obtain or construct robust expenditure forecasts, which is discussed in section 6. Indeed, this compromises the certainty which the ACCC is aiming to achieve.
- 5.37 To add support to its decision, the ACCC has also drawn on the example of the length of the regulatory period in the UK water industry and the Australian electricity industry.<sup>78</sup> Optus submits that the ACCC's comparison to these benchmarks is misplaced since fundamentally different circumstances apply in these industries.
- 5.38 The water and electricity industries are currently experiencing very little technological change. This means that the costs facing the businesses are not changing dramatically as a result of the underlying service delivery. Of course, these industries are facing their own challenges, such as droughts and peak demand growth, but the means and costs to address these challenges are not significantly different from a decade ago. Further, the demand for these services has not been significantly challenged with the introduction of substitutes. Therefore, a longer regulatory period poses less risk to access seekers and the provider that costs (or demand) will fundamentally shift within a five year period. Also the regulatory regime in these industries is more stable and settled.
- 5.39 In contrast, the telecommunications industry has changed significantly in the last decade in regard to the underlying service delivery and consumer demand given substitutes. The advent of the NBN represents an obvious catalyst to change the underlying costs facing Telstra within the next five years, in addition to the changes that cannot be foreseen but are more likely given the dynamic nature of the industry. A shorter regulatory period will allow for changes to be incorporated into prices closer to the date when they are known. This reduces risks to both access seekers and the provider. Also the proposed new regulatory regime is not yet bedded down.
- 5.40 Consequently, a shorter regulatory period offers the following advantages:
- a) Prices will be more closely tied to costs actually incurred, as there would be more frequent reviews;
  - b) Costs to be more accurately forecast, especially in the context of dynamic industry changes; and
  - c) The ACCC to gain more experience and expertise of Telstra's business through more frequent reviews.
- 5.41 The implication of a shorter regulatory period is that prices are more likely to reflect recently assessed costs.

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<sup>78</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 36

## Section 6. The Fixed Line Services Model

- 6.1 In this section Optus has set out its views on a number of issues related to the Fixed Line Services Model and other issues related to the setting of access prices, including:
- (a) the proposed capex and opex forecasts;
  - (b) the Weighted Average Cost of Capital;
  - (c) the ACT Utilities Tax;
  - (d) cost allocation;
  - (e) LSS pricing;
  - (f) demand forecasts; and
  - (g) connection and disconnection charges.

### Capex and opex forecasts

- 6.2 Under the ACCC's fixed line services model (FLSM), forecasts of Telstra's capital expenditure (capex) and operating expenditure (opex) are required as inputs into calculating prices for the estimation period.<sup>79</sup>
- 6.3 Following the release of the ACCC's Draft Report in September 2010,<sup>80</sup> Optus submitted a number of concerns with the capex and opex forecasts (as did other parties), many of which have been taken into account by the ACCC in the current FLSM. There still remain, however, a number of matters to be addressed for the FADs.
- 6.4 Whilst the ACCC has stated that it will approach this issue by scrutinising a complete set of information submitted by Telstra, in practice its actual approach has been to develop its own forecasts. The ACCC has noted its intention to separately consult on a BBM record keeping rule (RKR) in order to obtain sufficient information from Telstra. However, this overlooks the need for a robust forecast for the current period.
- 6.5 Below Optus will present alternative approaches to the specific forecasts put forward by the ACCC in particular areas. With regard to indirect capital costs, for example, Optus is concerned that the ACCC proposes to adopt a high markup with little justification. Optus will argue that the ACCC should use the markup adopted in the Analysys model.
- 6.6 Overall, Optus argues that the ACCC needs to reconsider its approach to gathering and assessing inputs to access prices for the current period.

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<sup>79</sup> Capex is not a direct component of the revenue requirement but is rolled into the RAB, which is used to determine the return on and return of capital.

<sup>80</sup> ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services: Draft Report*, September 2010.

## Comments on the expenditure forecasts

### *Selection of an appropriate base year*

- 6.7 In November 2010, Telstra provided the ACCC with historic opex for the financial years 2008-09 and 2009-10, in a manner which was consistent with the RAF RKR. It did not provide the ACCC with an opex forecast for the five year regulatory period.
- 6.8 However, following a further request for information from the ACCC regarding opex forecasts, in April 2011 Telstra advised that its opex forecast should increase in 2010-11 by **CiC**. This increase was said to relate to forecast opex growth on all services, excluding Sensis and international entities.
- 6.9 The ACCC rejected Telstra's forecasts on the basis that it "does not have sufficient evidence to justify revising its operating expenditure forecasts for the fixed line services on the basis of Telstra's advice".<sup>81</sup> Optus agrees with the ACCC's decision to reject Telstra's opex forecast.
- 6.10 Given that the ACCC had not received an acceptable forecast from Telstra, it constructed an opex base year to apply the growth rate. The base year for direct opex was determined by Telstra's most recent submitted historic opex (2009-10) for the CAN, and for the CORE an average of the last five years was utilised.
- 6.11 Optus questions the ACCC's proposal to use two different methods to establish the base year for direct opex for the CORE and CAN. The ACCC stated that "[i]n contrast to CAN operating costs, operating expenditure on the Core network has been largely stable in real terms over recent years".<sup>82</sup> If that is the case, it seems unnecessary to apply a different approach as a stable average should result in a similar 'last year' value to the average. However, without Optus being able to review the historic values it is difficult to ascertain the effect of this decision.
- 6.12 Optus agrees with the ACCC's decision to adopt Telstra's capex forecast as the base year. Since there has been a step change in expected expenditure given the first six months of the year compared to the last full historic year, a forecast which is based on the most relevant information appears appropriate.

### *Derivation of an appropriate growth rate*

- 6.13 In addition to Telstra's forecast capex for the 2010-11 year, Telstra also submitted that it was "currently updating its capital expenditure forecasts for the regulatory period" but the ACCC could adopt a nominal annual increase of **CiC** to the revised 2010-11 expenditure forecast.<sup>83</sup>
- 6.14 Optus submits that given the material change between the 2009-10 year and the forecast for 2010-11 it may be an overestimate of costs to accept Telstra's submitted growth rate, no matter how small. It has been the unanimous view of industry that Telstra's investment in the CAN and CORE will be limited, given the impending introduction of the NBN.

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<sup>81</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 111

<sup>82</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 112

<sup>83</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 78

- 6.15 Therefore, Optus submits that the ACCC should amend the capex forecast to reflect zero nominal growth. That is, the capex forecast should decline in real terms by the full change in inflation. Without further information or substantiation from Telstra, it is unreasonable to impose increasing nominal costs on access seekers. As well, given that it is likely that more substantial capex reductions will be made, zero nominal growth is conservative.
- 6.16 In response to the September Report, Optus argued that since services on the PSTN are declining, Telstra's opex is also likely to decline. Of course as the ACCC noted, as assets age maintenance costs would be expected to increase. This is because the continued use wears the assets and as a result break downs are more frequent. However, given that Telstra is expected to shut down its network as NBN migration progresses, Telstra has a very strong incentive to incur expense only when absolutely necessary. This means that where some maintenance activities may have been carried out on a regular basis to prolong the life of the assets, Telstra will likely forgo such activities in future and only attend to network elements if it affects service levels directly. Further, as volume and customer numbers fall, faults and call-outs are likely to occur less frequently than if the assets were fully utilised.
- 6.17 Therefore, Optus proposes that a constant zero nominal growth rate should be utilised for the opex forecast as well. This means that a small real reduction in allowed expenditure will be built into the forecast. Optus submits that this would be a reasonable assumption on the part of the ACCC as it can be expected that cost reductions will occur as use of the network is declining. Without further information on the expected changes in costs, a small real reduction should not have adverse affects on Telstra's ability to recover its costs.
- 6.18 Furthermore, since Telstra's reasons for an increasing opex forecast were rejected and the ACCC recognised that Telstra is likely to be making savings in its opex spend, the ACCC should be reducing forecast opex, rather than maintaining the existing level.

#### *Inclusion of appropriate indirect costs*

- 6.19 Telstra has not provided information to the ACCC regarding its forecast level of indirect capital costs. Instead, the ACCC has assumed that indirect capex will be related to the annual depreciation charge of the capital programme.
- 6.20 In response to the September Report Telstra stated that by the exclusion of indirect capital costs the revenue requirement was underestimated by \$168 million in 2010/11.<sup>84</sup> Tellingly, Telstra refers to cost estimates from the Analysys Model, which was developed over three years ago prior to the now certain decision regarding the NBN, and its own estimates which were **CiC**.
- 6.21 Optus submits that indirect capex should not be included in the forecast, given that Telstra has been unable to provide an adequate forecast or substantiation of these costs. Since Telstra describes its indirect costs as being comprised of primarily IT assets and administration, it is unlikely that in the context of declining demand many new systems will need to be purchased or developed. That is, it is most likely that Telstra's capex will relate to replacing assets that are necessary to provide services using existing technology and little overheads to implement.
- 6.22 For indirect opex, the ACCC has applied a mark-up on direct opex of 80% to establish a forecast. The 80% figure has been selected as the midpoint between the 60% utilised in the Analysys model and the 100% the ACCC calculated using Telstra's RAF accounts over the period 2003/04 to 2008/09.

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<sup>84</sup> Telstra, *Pricing Principles for Fixed Line Services Response to the ACCC's Draft Report*, October 2010, p. 63

6.23 The ACCC stated that it viewed its calculated figure as an upper limit because:

*The ACCC has assumed that Telstra's recent and announced cost cutting measures will be concentrated on indirect operating costs.*<sup>85</sup>

6.24 Optus agrees with the contention that Telstra's recent and announced cuts have concentrated on reducing corporate overheads.

6.25 However, the ACCC has not described the methodology it has used to calculate the direct to indirect cost ratio utilising Telstra's RAF reports. It is particularly concerning given that the Analysys figure was derived using the same data source and there is a material difference between the two values. Analysys utilises Telstra's 2007 RAF reports to disaggregate network and business overhead costs relevant to the fixed network to calculate the ratio.<sup>86</sup> Optus is unable to compare the approaches since it does not have access to Telstra's RAF reports. However, Optus has reviewed the documentation of Analysys' approach and it appears appropriate.

6.26 That said, Optus disagrees with the ACCC's rationale for viewing the Analysys figure as a lower limit. The ACCC gives two reasons in support of its view:

(a) *Indirect costs have been optimised in the Analysys model; and*

(b) *Telstra's existing assets, which vary in age and technology, are likely to require greater maintenance and associated indirect costs than the new, optimised assets assumed in the Analysys model.*<sup>87</sup>

6.27 Firstly, the optimisation which occurs in the Analysys model relates to the configuration and technological specifications of the network components. This is because the main reasons for building a bottom up cost model (and optimising) are to establish the regulatory asset base. Therefore, much of the focus is on the capital expenditure, rather than a whole of business approach to costing.

6.28 The mark-up for indirect costs in the Analysys model were calculated using Telstra's RAF reports.<sup>88</sup> Specifically, total network operating costs and business overheads costs were calculated using the RAF data. Then the mark-up (business overheads) figure was calculated as a share of the network costs. This means that the mark-up figure has been calculated independent of the optimisation that has occurred in the network modelling. That is, the ACCC's assumption above is incorrect: in fact, indirect costs have *not* been optimised in the Analysys model. It follows that the Analysys mark-up figure is an appropriate figure to be used as a mark-up on direct opex in the FLSM.

6.29 Secondly, since indirect costs relate to corporate overheads, which was recognised by the ACCC, the age and technology of the network elements should have no bearing on the level of these costs. Indirect costs are by definition costs that cannot be attributed to particular activities of

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<sup>85</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.114

<sup>86</sup> Analysys, *Fixed LRIC cost model documentation*, 17 December 2008, pp.122-132

<sup>87</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.114

<sup>88</sup> Analysys, *Fixed LRIC cost model documentation*, 17 December 2008, p.122



the business. Maintenance on network assets is a direct cost and the amount of which should have no material impact on overhead costs (indirect).

- 6.30 Therefore, given that the ACCC's arguments to view the Analysys figure as a lower limit are invalid and without access to Telstra's RAF accounts to examine the ACCC's calculation, Optus proposes that the ACCC adopt the Analysys mark-up value of 60%.

#### *Appropriate allocation of forecast opex and capex*

- 6.31 The ACCC has maintained its approach from the September Report to allocate opex using undepreciated asset values. Optus maintains its support as this methodology presents a transparent mechanism to approximate the most likely drivers of opex.
- 6.32 For capex allocation, the ACCC has accepted the detailed allocation submitted by Telstra since the September Report. In doing so, the ACCC reviewed Telstra's information with regard to historic trends and expectations for certain asset class investment given demand conditions and the NBN. Optus recognises this as an improvement over the ACCC's previous approach which took into account remaining asset life, asset size and expected demand in a more opaque manner.

#### *Conclusions on the robustness of the ACCC's assessment approach*

- 6.33 For the September Report the ACCC was unable to obtain forecast capex or opex from Telstra. It thereby established a forecast using information available to it from Telstra's regulatory accounting reporting in addition to publicly available information, such as annual reports.
- 6.34 Optus recognises that for the Discussion Paper, the ACCC has had regard to more information provided by Telstra in response to further requests for information and as part of its submission to the September Report. However, as the ACCC stated:

*forecasts were not provided for the entire proposed regulatory period. Further, the explanatory material provided with the forecasts was insufficient to enable a full assessment by the ACCC of the basis for the forecasts.<sup>89</sup>*

- 6.35 Therefore, the ACCC has appeared to assess the robustness of Telstra's forecasts by comparing them to the much higher forecasts the ACCC derived for the September Report and the limited substantiation provided by Telstra and public information.
- 6.36 The ACCC has stated that it will assess expenditure forecasts by requiring Telstra to:
- (a) *Provide a detailed explanation of the information, assumptions and cost drivers used to develop its forecasts for the coming regulatory period. The ACCC will publish the explanation during the consultation process for the price reset; and*
  - (b) *Explain any significant differences between its forecasts for the previous regulatory period and its actual expenditure over the period.<sup>90</sup>*

- 6.37 Specifically for capex, the ACCC also included a requirement for Telstra to produce a copy of its internal investment guidelines used to rank capital expenditure projects.

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<sup>89</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.34

<sup>90</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.82 and 114

6.38 Although the ACCC has stated that these requirements will apply “in future price resets”,<sup>91</sup> there is no justification or explanation regarding the reasons for not subjecting the current “price reset” to the same level of rigour. The ACCC has indicated that it will be consulting separately in due course on the timeframe and requirements for a BBM RKR. Indeed, the ACCC said a RKR would:

*clearly specify the information required, the nature of the supporting information required, the format for presenting the information, and timeframes for providing it.*<sup>92</sup>

6.39 Although the ACCC has stated that the RKR will provide “transparency for all industry participants” it is not clear why that transparency must be compromised for prices that will be set for the next *five years*. It is clear that the ACCC has not been able to carry out a robust assessment as intended due to information limitations. This raises concern that either:

- (a) Telstra is *unable* to provide the level or extent of information requested by the ACCC due to the length of the forecasting period. The implementation of a RKR will do nothing to remedy this problem and so the regulatory period should be shortened accordingly; or
- (b) Telstra is *unwilling* to provide the level or extent of information requested by the ACCC. The implementation of a RKR should be brought forward to compel an appropriate assessment be undertaken prior to prices being locked in.

6.40 In its response to the September Report Telstra stated that:

*the process for obtaining capital expenditure forecasts needs to form an integrated part of the BBM/Pricing Principles and that it is unnecessary and inappropriate to do this separately through an RKR...*

*Given the highly uncertain environment, unlike other sectors that adopt BBMs, it is not possible for the ACCC (or Telstra) to reliably forecast capital planning requirements in relation to the CAN and IEN over a period of 4 years.*<sup>93</sup>

6.41 When these statements are taken in combination with the additional information provided to the ACCC since the September Report, it would appear that the length of the regulatory period is a key barrier. As discussed above, Optus proposes that the length of the regulatory period be shortened.

6.42 In either case, the arrangements for gathering and assessing Telstra’s information are not separate to setting future prices; they are an important component and should be immediately addressed. Optus submits that without proper consultation and understanding of the mechanisms for price resets, the BBM will fail to deliver on its intended benefit. This is because the BBM requires thorough examination during consultations, indeed the ACCC stated that it:

*considers that sufficient transparency in the information supporting the forecasts and careful scrutiny during the consultation process for the price reset will maximise the likelihood that the forecasts will not include significant inefficiencies or inflated costs.*<sup>94</sup>

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<sup>91</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.82

<sup>92</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.34

<sup>93</sup> Telstra, *Pricing Principles for Fixed Line services Response to the ACCC’s Draft Report*, October 2010, p.95 and 98

- 6.43 It is Optus' experience that robust engagement with industry is vital to ensuring the ACCC's intended outcomes. Without a clear framework and sufficient time, the ability for any party to appropriately gather and consider the information is compromised.

### **Weighted Average Cost of Capital**

- 6.44 Optus submits that it is broadly supportive of the ACCC's approach to setting the weighted average cost of capital (WACC). Below Optus sets out brief comments on the parameters utilised to calculate the two cost components that determine the WACC: the cost of debt and the cost of equity. More substantial comments on the value of gamma are provided separately.

#### Cost of debt

- 6.45 Optus supports the continued adoption of a *debt gearing level* of 40%, given the evidence before the ACCC.
- 6.46 The ACCC has estimated *debt issuance costs* of 8.3 basis points using the approach developed by the Allen Consulting Group. Optus supports the methodology and the associated assumptions utilised by the ACCC and submit that the derived costs appear reasonable.
- 6.47 Optus does not oppose a *debt beta value* of zero.

#### Cost of equity

- 6.48 Optus submits that the ACCC's approach to estimation of the *risk-free rate* remains appropriate. The increase in the sampling period of the CGS bond rates to 20 days from the 10 days utilised in the September Report is consistent with other regulators and potentially mitigates the inclusion of daily volatility in the value. Further, Optus agrees that the sample should be taken as close as practicable to the commencement of the period for which the rates will apply.
- 6.49 Optus also supports the ACCC's adopted value of 6% for the *market risk premium*. Given that the market risk premium is a long term, economy wide measure, any increase to reflect the transient effect of the global financial crisis in Australia is not reflective of the long term view. Further, the effect of the global financial crisis in Australia has been very limited, and so the value of 6.5% which was adopted in a previous decision by the AER should be viewed as an outlier. Indeed, the ACCC's evidence suggests that the long term value of 6% can be viewed as appropriate.<sup>95</sup>
- 6.50 Optus recognises the inherent difficulty in estimating an appropriate *equity beta* for Telstra's business. Although Optus considers the ACCC's adopted value of 0.7 is likely to overestimate the level of systematic risk in Telstra's fixed-line business, Optus agrees that the benchmarking approach used to determine the equity beta addresses Telstra's concerns regarding market views of its business in the context of the resources boom.
- 6.51 Optus agrees with the ACCC that any *equity issuance costs* be recovered in operating expenditure, rather than as a component of the cost of equity.

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<sup>94</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.115

<sup>95</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, pp.89-90

## Gamma

- 6.52 Optus does not support the ACCC's decision to adopt an *imputation factor (gamma)* of 0.45. The reasons given for the ACCC's decision are that:

*After considering the available information and submissions set out above, the ACCC's view is that a benchmark economy-wide gamma is preferred to a business-specific approach to setting gamma because the **benchmark approach provides strong incentives to operate efficiently.***<sup>96</sup> [emphasis added]

- 6.53 Firstly, the use of the benchmark approach is not appropriate in telecommunications. The AER is required to use an economy-wide approach in the energy sector as WACC parameters are to be set with regard to benchmark standards of efficiency using the financing structure of a benchmark firm. These requirements are set out in the National Electricity Rules and the National Gas Rules. In contrast, the ACCC is required to make decisions with regard to the long-term interests of end-users, which includes the legitimate business interests of the access provider. This means that the ACCC is not required to provide a return on capital at a benchmark level. Rather, the ACCC's primary consideration in setting an appropriate WACC is to ensure that Telstra is able to recover its costs, and no more. (Provided this requirement is met, the competition and investment criteria are unlikely to point to a different WACC value.)
- 6.54 Secondly, it is certainly not in the long-term interests of end-users to have prices knowingly set higher than costs in order to provide 'incentives to operate efficiently'. Further, Optus has described at length in section 5 that Telstra already faces sufficient incentives to operate efficiently by nature of the structure of its business and the external conditions in which it is operating. It is therefore inappropriate for the ACCC to adopt a WACC parameter that will definitely allow Telstra to over-recover costs.
- 6.55 Finally, the information and submissions to which the ACCC refers relate only to Telstra's position since Optus supported the previous gamma value of 0.65. Telstra submitted that its actual payout ratio was 0.9, yet does not account for the discrepancy between this stated value and that calculated by the ACCC using Bloomberg data. Further, Telstra refers only to empirical studies of the value of theta to arrive at an average value of 0.4. Telstra does not provide any substantiation on why the studies are appropriate for estimating theta relevant to its services.
- 6.56 Optus recognises that there is uncertainty in setting an appropriate gamma, however much of the uncertainty which faces the AER is driven by the requirement to have regard to a benchmark gamma. The ACCC's task is arguably simplified given that its primary consideration in setting an appropriate WACC is to provide for Telstra to recover its costs.
- 6.57 Optus therefore submits that the ACCC's previous approach is an appropriate method by which to set the gamma. In the case of Telstra, the payout ratio is measurable (the ACCC calculated 99.4%) and there is a limit on foreign investment (35%) which would influence the value of the credit. Optus submits that the ACCC's previous assumption that the remaining shareholders (domestic) will fully value the franking credit is appropriate since all shareholders receive a tax benefit, no matter what their tax liabilities. Therefore, Optus proposes that the ACCC adopt a gamma of 0.65 as it is an appropriate value which will allow Telstra to recover its costs.

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<sup>96</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.103

## Tax

- 6.58 The ACCC has requested views on the appropriate method for the recovery of the ACT Utilities Tax.<sup>97</sup> As acknowledged by the ACCC, the tax only applies within the Australian Capital Territory and the Jervis Bay area. It is therefore inappropriate for the tax liability to be included in the revenue requirement of the FLSM. It should not be included in access prices or in connection and disconnection charges. Therefore, Optus proposes that that payment of this tax should be a matter which the parties address in the agreements under which the service is supplied, in a commercially acceptable manner.
- 6.59 Nevertheless, Optus wishes to take this opportunity to raise a number of issues with Telstra's current practice with regard to calculation and pass-through of the tax. It was noted by the ACCC that Telstra currently passes on the tax via a monthly utilities tax charge imposed on eligible wholesale services provided in the ACT and Jervis Bay areas.<sup>98</sup> Section 2.8 of Telstra's wholesale customer terms document states that:

*If a utilities tax is payable by us, or assessed as being payable by us, in relation to the infrastructure used by us to provide a service to you, we will charge you an amount to recover the utilities tax ("utilities tax charge") as set out below for each eligible service you acquire from us if the place where your eligible service is provided is listed in the table below:*

<b>LOCATION WHERE UTILITITES TAX IS PAYABLE</b>	<b>MONTHLY UTILITITES TAX CHARGE (GST EXCL.)</b>
<i>Australian Capital Territory and Jervis Bay, New South Wales</i>	\$2.02

*Wholesale customers are only required to pay a utilities tax charge under this Wholesale Services Section if Our Customer Terms and not under any other section of Our Customer Terms.*<sup>99</sup>

- 6.60 The structure of the charge in Telstra's customer terms is different to the manner in which the tax is levied on Telstra. As stated by the ACCC:

*The ACT Utilities Tax is levied **per kilometre of the utility network**.*<sup>100</sup> [emphasis added]

- 6.61 Clearly, Telstra has performed a number of cost allocations and calculations in order to convert the per kilometre charge into a per service charge for wholesale customers. However, this process which Telstra has undertaken is not transparent.
- 6.62 Optus submits that it is imperative for Telstra to enter into a dialogue with its wholesale customers and provide information in a transparent manner on the method by which it converts

<sup>97</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.178

<sup>98</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 178

<sup>99</sup> Telstra, *Our Customer Terms: Wholesale Services Section*, last updated 17 December 2010, p.5

<sup>100</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p.178

the tax into a charge which it is seeking to impose on its customers. This is because Telstra's wholesale customers are not the majority users of its network: the majority of Telstra's network users are its own retail customers. It is therefore important to ensure that an appropriate share of the tax is absorbed by Telstra's internal use (to provide services to its retail customers) such that external wholesale customers are not adversely affected. Any arrangement for the recovery of the tax should be consistent with these principles.

## Cost allocation

- 6.63 The ACCC has made several revisions to specific asset classes considered in the FLSM, such as, the inclusion of additional asset classes, such as 'network land' and 'network building and support assets' and the removal of asset classes not applicable to declared fixed line services, such as 'satellite equipment' and 'international network cables'. In addition, special treatment was also given to the derivation of allocation factors for 'ducts and pipes' and 'copper cables', as well as for PSTN 'switching equipment'.
- 6.64 In making these revisions, the ACCC has adopted several approaches to derive the cost allocation factors for each asset class in the base year, including:
- (a) Applying a revised set of Analysys allocation factors to the corrected base year period, the ACCC has chosen to directly apply the allocations derived for a number of CAN and Core asset classes (subject to a demand-based adjustment factor).
  - (b) Developing a new methodology, taking into account geographic cost differences, to adjust the allocation of costs applicable to ULLS, WLR and other services for a number of CAN asset classes.
  - (c) Undertaking an adjustment to the PSTN OTA transmission equipment factor to take into account the significant increase in data traffic in recent years; and
  - (d) Deriving appropriate cost allocation factors for the new asset classes based on the Analysys model, or where this is not available based on a revenue share approach, as the starting point.
- 6.65 In general, Optus supports the ACCC's proposed changes to its cost allocation approach and in particular welcomes the inclusion of the 'cost allocation factors calculations' worksheet which has been included in the FLSM to increase transparency in the approach taken to calculate the cost allocation factors.
- 6.66 Optus appreciates that the ACCC has responded to our submission and changed its approach to cost allocation for copper line and duct costs used to set cost-reflective prices in the CAN. The ACCC has developed a methodology to adjust the allocation of costs to ULLS, WLR and other services (mainly Telstra's retail services) in order to reflect differential geographic costs.<sup>101</sup> Using this methodology, the ACCC has calculated the correct share of duct and pipe costs and copper cable costs which should be borne by the ULLS service, by revising its cost allocation factors for these assets. Optus considers that as a result of this process, the revenue requirement which the FLSM allocates to be recovered through ULLS access prices (from ULLS access seekers and their customers) appropriately reflects the differential costs of providing services in the different geographic bands, according to the relative number of ULLS SIOs in each band. Optus supports the proposed revised approach to cost allocation for copper line and duct costs.

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<sup>101</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, pp.140-142 and 151-153

6.67 A further discussion of Optus' specific comments (and possible amendments) regarding the ACCC's changes to its cost allocation approach is set out in Appendix F.

### LSS pricing

6.68 The ACCC proposes to set prices for the line sharing service (LSS) which reflect only indirect costs, and which do not include any contribution to network costs. This means that the LSS access charge will not make any contribution to the common costs of the infrastructure over which the service is carried, Telstra's customer access network (CAN).

6.69 The reason for the ACCC's approach is that Telstra already recovers the costs of its CAN through revenue from other services:

*In estimating the LSS-specific costs, the ACCC has excluded network costs because these costs are recovered through the prices charged for WLR and Telstra's retail line services.*<sup>102</sup>

6.70 Optus considers that the ACCC's approach under which the LSS does not bear any share of common line costs is inappropriate and inconsistent with the legislative criteria. In particular, this approach is likely to distort consumption by encouraging the use of the LSS (which is priced below the cost-reflective level) and discouraging the use of alternative services. The differential treatment of the LSS access option also does not promote competition, since by under-pricing the LSS it tilts the playing field in favour of LSS-based access seekers and precludes competition 'on the merits'. The ACCC is on record as being in agreement with this principle; it stated in 2007 that "...economic efficiency can be enhanced by the inclusion of an appropriate contribution to line costs in LSS annual charges."<sup>103</sup>

6.71 In order for LSS charges to include an appropriate contribution to line costs, there would need to be an offsetting 'rebalancing' of other charges, particularly the wholesale line rental charge, in order to prevent over-recovery. The ACCC has also recognised this requirement:

*However, where line rental charges fully recover costs, the inclusion of such a contribution in LSS annual charges would lead to an over-recovery of cost. In these circumstances, reductions in charges for other network services, such as wholesale line rental, are needed in order to avoid any such 'double dipping'.*<sup>104</sup>

6.72 Such a rebalancing would not be difficult to achieve, however, as Telstra has noted:

*LSS and WLR charges could be rebalanced within a matter of weeks of the Commission advising its view on the amount of line cost that should be allocated to each service.*<sup>105</sup>

6.73 The ACCC's FLSM allocates costs according to the principle that cost allocation factors should represent the share of costs incurred – and network elements used – in supplying a particular

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<sup>102</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.156

<sup>103</sup> ACCC, *Access Dispute between Chime-Telstra – Line Sharing Service (LSS)*, Final Determination and Associated Statement of Reasons, 12 July 2007, p.1

<sup>104</sup> ACCC, *Access Dispute between Chime-Telstra – Line Sharing Service (LSS)*, Final Determination and Associated Statement of Reasons, 12 July 2007, p.1

<sup>105</sup> ACCC, *Access Dispute between Chime-Telstra – Line Sharing Service (LSS)*, Final Determination and Associated Statement of Reasons, 12 July 2007, p.26

service.<sup>106</sup> Optus submits that the same principle should be applied in determining access prices for the LSS. The LSS should bear its 'fair share' of the costs of the CAN. The current consultation provides an opportune time for the ACCC to reconsider the scope for rebalancing in order to achieve this objective.

## Demand forecasts

6.74 An important issue in the area of demand forecasting relates to NBN migration. According to the ACCC's discussion paper, migrations to the NBN that cause actual demand to differ from the ACCC's demand forecasts will not result in adjustments to access prices. The reason stated for this result is that the ACCC's cost allocation adjustment methodology "effectively holds unit costs constant".<sup>107</sup>

6.75 Optus submits that it is appropriate that access prices will not be increased as a result of migrations to the NBN reducing the demand for services on Telstra's CAN. If this position were different, and access prices were increased, then Telstra would be compensated twice for each customer migration, once by NBNCo through its migration payments (which the ACCC has taken into account neither in calculating Telstra's initial RAB nor through the depreciation schedule) and a second time by its remaining customers on the CAN through higher access prices. This would inevitably allow Telstra to over-recover its costs.

6.76 Nevertheless, it appears that the ACCC's treatment of this issue may not be settled. In particular, the ACCC has noted that it may reduce demand forecasts in future to take account of NBN migration when information becomes available, stating that:

*To date, the ACCC has not received sufficiently detailed or certain information on the planned migration timetable to adjust its demand forecasts for migration to the NBN. Should better information become available about the magnitude and timing of the migration process prior to finalising prices for the FADs, the ACCC may adjust its demand forecasts and cost allocation factors.*<sup>108</sup>

6.77 Optus is concerned at this suggestion, particularly given that the ACCC appears to be minded not to take into account the ongoing payments Telstra will receive from NBNCo in exchange for both access to Telstra infrastructure and the progressive migration of customers from Telstra's copper and cable access networks to the NBN, together valued at close to \$9 billion in net present value terms. If the ACCC decided to revise downwards its demand forecasts for all CAN SIOs at the beginning of the next regulatory period, without taking into account the payments from NBNCo, then Telstra would over-recover its costs and make a windfall gain. In these circumstances, the ACCC would be taking into account the impact of the NBN on one side of the ledger, but failing to take it into account on the other side.

6.78 Optus submits that if NBN migration is to be taken into account at any point in the future, then it is all the more essential that the ACCC also takes into account both migration compensation payments and the ongoing payments Telstra will receive from NBNCo in exchange for both access to Telstra infrastructure.

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<sup>106</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.123

<sup>107</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.128

<sup>108</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.128



## Connection and disconnection charges

- 6.79 While Optus generally supports the ACCC's continued use of the approach taken to set connection and disconnection charges identified in previous arbitral determinations, Optus considers that the indexation approach may have been inappropriately applied in the context of the draft FADs.
- 6.80 The ACCC has set its draft FAD prices based on the indicative ULLS connection charges set out in the 2009 ULLS Pricing Principles Determination, and indexed using a CPI inflator for each subsequent period. Optus submits that as a result of this indexation approach, the draft FAD prices are likely to over recover the efficient costs of ULLS connection charges.

### Application of the ACCC's CPI indexation

- 6.81 The ACCC has maintained its view that the CPI provides a good approximation of wage growth in the communications sector.<sup>109</sup> While Optus does not dispute the use of the CPI index as a suitable inflator, it is concerned that the ACCC has incorrectly applied the indexation in its derivation of connection charges in the draft FADs.
- 6.82 For example, by setting charges based on the inflated value of the indicative price established during the last regulatory process, the ACCC is incorrectly assuming that the connection charge is entirely comprised of labour costs.
- 6.83 However, the ACCC has previously identified the efficient costs of ULLS connection and disconnection charges and recognised that:

*connection charges should be set with reference to the amounts charged by third party contractors to Telstra for jumpering work in exchanges, indirect costs and back-of-house costs.*<sup>110</sup>

- 6.84 In addition, the ACCC has also previously concluded:

*The level of prices resulting from the ACCC's approach may appear to be high, and in particular, lead to a counterintuitive result of ULLS connection prices being significantly higher than LSS connection prices. The ACCC expects, however, that these ULLS connection prices will fall in later periods following the cessation of routine cutover testing and consequent expected reduction of contractor rates. **In particular, the ACCC notes that jumpering quotes should, in due course, at least fall below the costs for LSS connections and should approach costs of PSTN connections.***<sup>111</sup> [emphasis added]

- 6.85 As such, by applying the CPI inflator to the final connection charge, the ACCC has assumed that the each component comprises labour costs that are expected to change over time at the same rate. Yet this is counter to the conclusion the ACCC has noted above.

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<sup>109</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.174

<sup>110</sup> ACCC, *ACCC pricing principles for the unconditioned local loop service (ULLS) determination 2009*, Schedule 3

<sup>111</sup> ACCC, *Unconditioned local loop service – Pricing principles and indicative prices*, June 2008, p.31

6.86 To illustrate this point, let us assume that the total cost of ULLS connection charges can be disaggregated into its individual components – jumpering costs, indirect costs,<sup>112</sup> and back of house costs. A proportional assumption is then applied for jumpering costs, which subsequently dictates the proportion of costs attributable by each of the remaining components to set the base case. For simplicity a CPI inflator of 2.7% has been applied to show the change in the proportion of costs attributable to each component to the total connection charge. These assumptions are outlined in the table below.

		Base Case	CPI applied to all categories	CPI applied to back of house costs only
Jumpering costs	To be conservative assume this is 50% of the total cost	50%	50.00%	49.40%
Indirect costs	Mark-up on the jumpering costs	5%	5.00%	4.94%
Back of house costs	Differential (excluding the jumpering and indirect costs)	45%	45.00%	45.66%
Impact on total cost			2.7%	1.21%

6.87 While the ACCC has set connection charges with reference to amounts charged by third party contractor for jumpering work in exchanges, it may not have necessarily taken into account the observation that jumpering costs should in due course decline, and converge towards the connection costs relevant to LSS and PSTN connections. As shown in the example above, this can be illustrated by not allowing for any CPI adjustment for jumpering costs, which will in turn reduce the proportion jumpering and indirect costs contribute to the overall connection charge.

6.88 However should the ACCC consider that an adjustment be applied to jumpering costs, it must make several qualifications, including:

- (a) Justification that this adjustment is necessary given that jumpering costs comprise of more elements than just labour costs, eg. travel and tool costs.
- (b) Evidence to support the ACCC’s previous assumption that jumpering costs were likely to decline is no longer applicable.

6.89 Absent these qualifications, it is not reasonable to accept that jumpering costs should be indexed at the same CPI inflator. However should an inflator be applied, this should be set at a level that is lower than the forecasted CPI inflation.

6.90 The above example highlights a significant flaw in the ACCC’s approach. Indexation applied to the total cost will lead to an over recovery of the efficient costs of connection charges. Furthermore the level of this difference will be dependent on the assumption applied to the proportion of costs attributed to jumpering costs and the indexation factor to be applied.

6.91 This level of over recovery is further compounded given the current approach is to set prices based on the indexed value of connection charges set in the preceding year.

### Charges for connection and disconnection

6.92 The following table sets out the ACCC’s CPI indexation factor and the resulting ULLS connection charges derived for each period.

<sup>112</sup> This mark-up is assumed to be 10%, consistent with that established during past regulatory processes.

CPI inflator applied	2.7%	1.25%	2.75	3%	2.5%	2.5%
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	1 Aug 2009 to 31 Dec 2010	IAD (Jan 2011 to Dec 2011)	FAD (Jul 2011 to Jun 2012)	FAD (Jul 2012 to Jun 2013)	FAD (Jul 2013 to Jun 2014)	FAD (Jul 2014 to Jun 2015)	FAD (Jul 2015 to Jun 2016)
Band 1	\$50.40	\$51.76	\$52.41	\$53.85	\$55.46	\$56.85	\$58.27
Band 2	\$53.10	\$54.53	\$55.22	\$56.73	\$58.44	\$59.90	\$61.39
Band 3	\$57.70	\$59.26	\$60.00	\$61.65	\$63.50	\$65.09	\$66.71

6.93 Optus considers that should the assumptions set out in the example be applied, this would result in the following ULLS connection charges.

CPI inflator applied	2.7%	1.25%	2.75	3%	2.5%	2.5%
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	1 Aug 2009 to 31 Dec 2010	IAD (Jan 2011 to Dec 2011)	FAD (Jul 2011 to Jun 2012)	FAD (Jul 2012 to Jun 2013)	FAD (Jul 2013 to Jun 2014)	FAD (Jul 2014 to Jun 2015)	FAD (Jul 2015 to Jun 2016)
Band 1	\$50.40	\$51.01	\$51.30	\$51.95	\$52.68	\$53.30	\$53.94
Band 2	\$53.10	\$53.75	\$54.05	\$54.74	\$55.50	\$56.16	\$56.83
Band 3	\$57.70	\$58.40	\$58.73	\$59.48	\$60.31	\$61.02	\$61.76

6.94 As a result, Optus submits that the ACCC should reconsider its approach to setting ULLS connection charges and ensure that any approach taken does not result in the setting of charges above efficient cost.

6.95 Optus notes that similar issues are likely to apply in respect of other charges, including call diversion charges and mass network migration charges.

## Section 7. Non-Price Terms and Conditions

- 7.1 The ACCC proposes to include non-price terms and conditions relating to access to the declared fixed line services in the FAD, in order to reduce the number of access disputes.
- 7.2 The non-price terms and conditions which were included in the interim access determination (IAD) are billing and notification, creditworthiness and security, general dispute resolution procedures, confidentiality provisions, communications with end-users, network modernisation and upgrade provision, suspension and termination, changes to operating manuals, ULLS ordering and provisioning (“the IAD non-price provisions”). The ACCC considers that these non-price terms and conditions are non-controversial.<sup>113</sup>
- 7.3 The ACCC has not included the liability (risk allocation) provisions, the intact vacant ULLS (iVULL) provisions and the facilities access provisions in the IAD as it considers there may have been significant change from current or past arrangements between the parties on these provisions and thus further consultation with the industry is necessary. All the relevant provisions are adopted from the ACCC 2008 Model Terms and Conditions Determination (2008 Model Terms determination) and the ACCC ULLS access dispute arbitration determination made in 2010.
- 7.4 The ACCC has also sought Optus’ comments in response to each of the non-price terms and conditions which were outlined in the IAD.

### The inclusion of non-price terms and conditions in the FAD

- 7.5 Optus in general supports the inclusion of non-price terms and conditions relating to access to the declared fixed line services in the FAD. This applies in particular to the IAD non-price provisions.
- 7.6 While parties may already have Access Agreements in place, it will still be useful to include the IAD non-price provisions in the FAD. This will provide greater certainty to the industry and will provide parties with better guidance on what constitutes fair and reasonable conditions of access, especially in the case when an Access Agreement comes to an expiry or when parties wish to have the Access Agreement varied.
- 7.7 Optus further proposes that the ACCC include a non-price provision on enhanced service assurance for ULLS. **CiC**
- 7.8 **CiC**
- 7.9 Optus submits that the ACCC should not include the liability (risk allocation) provisions, the intact vacant ULLS (iVULL) provisions or the facilities access provisions in the FAD. Inclusion of these three provisions in the FAD would increase regulatory uncertainty and disrupt current industry processes.

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<sup>113</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, pp.188-190

- 7.10 Optus has previously submitted that the liability provisions outlined in the 2008 Model terms and conditions determination are unnecessarily complicated and appear to be a legacy of access agreements from the early 1990s. They do not reflect modern standards of drafting, which are more concise and straightforward.
- 7.11 The iVULL provisions and the facilities access provisions outlined in the 2008 Model Terms and Conditions determination also no longer reflect current industry practice. Parties have now come to a commercial agreement to adopt a different process to iVULL and the new process has already been implemented by Optus and other access seekers in the industry. Further, the ACCC has implemented other measures such as the Telstra Facilities Access Record Keeping Rule (RKR) in monitoring the Telstra Exchange Building Access (TEBA) queuing process.

### **Optus' comments in response to the drafting of the non-price terms and conditions**

- 7.12 While Optus in general supports the drafting of the proposed non-prices terms and conditions, it considers that more work is required on some of these provisions to better reflect the ACCC's in principle position. This in particular applies to the network modernisation provision and the ULLS ordering and provisioning process.

#### **Network Modernisation provisions**

- 7.13 Optus' past experience in regard to Telstra's network modernisation in South Brisbane suggests that the network modernisation provision outlined in the current IAD is not sufficient to ensure equivalence between Telstra and access seekers. The information supplied by Telstra is of limited use and does not assist access seekers to plan for the migration or to advise end users about the upgrade.
- 7.14 Optus therefore proposes that the ACCC include in the FAD the specific information Telstra must provide to access seekers when it notifies access seekers about the upgrade. This should include at a minimum the following information:
- (a) the alternative services available;
  - (b) the date of supply, pricing, interconnection requirements and technical specifications of the alternative services available;
  - (c) the planned migration process including the migration dates for individual services and the costs involved;
  - (d) the extent of the network upgrade;
  - (e) the exact services that will be affected;
  - (f) the exact manner in which the services will be affected, including whether the service will be affected, in whole or, in part; and
  - (g) the "cease sales date" for any new services.
- 7.15 The inclusion of these specific information requirements is important in reducing the effect on end-users. Without the information, access seekers are not in a position to know how to optimise their networks and services in the most efficient manner and in the timeframe provided by Telstra.

- 7.16 **ciC**
- 7.17 **ciC**
- 7.18 **ciC**
- 7.19 **ciC**
- 7.20 **ciC**
- 7.21 **ciC** This is not in the LTIE and will not promote competition in the relevant markets.
- 7.22 Optus further proposes that the ACCC request Telstra to provide access seekers with a forecast of forthcoming upgrades, including upgrades that involve only one ESA. While the current draft FAD already has a provision on a Coordinated Capital Works Program (CCWP) Forecast, Telstra is only obliged to provide the CCWP forecast when the upgrade involves more than one ESA.

7.23 **ciC**

7.24 Optus submits the inclusion of forecast upgrades that involve only one ESA will promote equivalence of access between Telstra and access seekers. An earlier notification would provide access seekers with an opportunity to make contingency plans and take the planned upgrade into account in their infrastructure planning and in their marketing. Access seekers might adjust a marketing campaign it would otherwise have carried out in the affected area.

ULLS Ordering and Provisioning

7.25 Similarly, Optus submits that the ACCC should further develop the non-price terms applicable to ULLS Ordering and Provisioning. Optus has encountered difficulties in respect of Telstra processes relating to lines that have complex services attached. A large number of ULLS service qualification (SQ) queries have been rejected by Telstra due to the presence of a complex service on the line. Telstra requires the end user to disconnect the complex service before they can connect their new services with Optus. However, disconnection of the complex service has not been straightforward, and Telstra's processes have not facilitated disconnection. This is because, first, Optus has not able to identify the type of complex service on the line and second, Optus does not have the ability to request Telstra to remove the complex service on the customers' behalf.

7.26 **ciC**

7.27 **ciC**

7.28 **ciC**

7.29 **ciC**

7.30 **ciC**

7.31 **ciC**

7.32 **ciC**

7.33 **ciC**

7.34 Further, Optus submits the current definition of “complex service” should be amended to reflect the definition adopted by the industry. An appropriate definition would be the definition stated in the ULL Ordering and Provisioning Code.

7.35 Further commentary on the proposed non-price terms provisions is included in Appendix G.



## Section 8. NBN-based Wholesale Services

- 8.1 The ACCC has sought submissions on whether the FAD for the WLR, LCS, PSTN OA and PSTN TA services should apply to NBN-based wholesale services.
- 8.2 In this section, Optus will argue that regulating both Layer 2 wholesale services and NBN-based wholesale services is not in the long term interests of end users (LTIE).

### Regulation is justified by the lack of effective competition

- 8.3 Overregulation can result in inefficiencies which may prevent the market from functioning properly and impose unnecessary regulatory burdens on the industry. The burden of regulatory compliance has long been recognised as a problem. For example in 2005 the Government announced the appointment of a Taskforce<sup>114</sup> to identify practical options for alleviating the compliance burden on business from Government Regulation.<sup>115</sup>

- 8.4 Regulation should therefore only be imposed when effective competition is absent in the relevant markets. Under Part XIC of the CCA a service is to be declared by the ACCC only if the declaration will promote the LTIE, and the Explanatory Memorandum to the CCA states that:

*...it is not intended that the access regime embodied in this Part impose regulated access where existing market conditions already provide for the competitive supply of services. In considering whether a thing will promote competition, consideration will need to be given to the existing levels of competition in the markets to which the thing relates.*<sup>116</sup>

- 8.5 Where an effective regulatory access regime already exists at the wholesale level, this will generally be sufficient to ensure an appropriate level of competition; in such circumstances it will not be necessary to impose a further layer of regulation. For example, in its 2010 review of Telstra's retail price control arrangements the ACCC recognised price controls would be most effective when applied *"in markets where the conditions for effective competition are not yet present"*<sup>117</sup>

- 8.6 The European Commission has stated in its recommendation on regulated access to Next Generation Access Networks (NGA) that regulated wholesale bitstream access is unnecessary if there is already effective competition in physical network infrastructure access:

*where physical access remedies suffice to create effective competition, wholesale bitstream access could be removed...*

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<sup>114</sup> The Government, Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business, Australian Government's Response

<sup>115</sup> As part of the review, the Government asked the Productivity Commission (PC) to undertake over five years, a series of annual reviews of the burdens on business from the stock of Commonwealth regulation. <http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2007/007.htm&min=phc>

<sup>116</sup> Explanatory Memorandum to the CCA

<sup>117</sup> ACCC, *Review of Telstra's price control arrangement*, 2010, p.13

*[c]ertain arrangements for co-investment by several players could result in the lifting of ex ante regulation<sup>118</sup>*

- 8.7 This view was shared by Dr Gunter Kneips and Zenhausern. They consider that regulatory interventions into competitive markets should be abolished and to regulate both the market for access to wholesale (physical) network infrastructure access at a fixed location (market 4) together with the market for wholesale broadband access (market 5) implicates overregulation:

*To maintain market 5 in addition to market 4 in the list of markets in need of sector specific regulation, implicates double regulation and therefore overregulation.<sup>119</sup>*

### **The supply of NBN-based wholesale services will be competitive**

- 8.8 Optus considers that the supply of NBN-based wholesale services will be effectively competitive.

- 8.9 Some important indicators in assessing effective competition are the level of concentration and the number of facilities based competitors. In the ACCC's final decision on Telstra's exemption applications in 2008, it adopted a rule of thumb to the effect that 'effective competition' required four or more competitors in the market. It stated:

*the level of ULLS-based entry will provide the basis for effective competition in the downstream markets leading to lower prices and better quality and differentiated service offerings. In addition, the presence of four ULLS competitors (including Telstra) will also provide an effective competitive constraint on Telstra at the wholesale level...<sup>120</sup>*

- 8.10 An equivalent rule of thumb could be used to assess the market for NBN-based wholesale services.

- 8.11 The NBN wholesale and retail business models are illustrated in Figure 3 below. NBN Co will provide Layer 2 wholesale services. Services providers are expected to acquire Layer 2 wholesale services from NBN Co and use their own infrastructure to provide either retail services to end users and/or provide 'value-added' wholesale services (including NBN-based wholesale services) to other retail service providers.<sup>121</sup>

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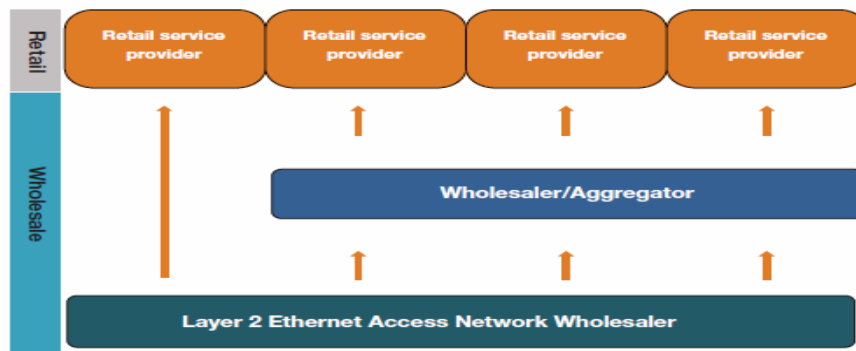
<sup>118</sup> European Commission, Commission Staff Working Document, Accompanying document to the Commission Recommendation on regulated access to Next Generation Access Networks (NGA) 2010, p21

<sup>119</sup> Dr Gunter Kneips & Zenhausern, "The reform of the European regulatory framework for electronic communications: the unexploited phasing-out potentials", Second Annual Conference of Competition and Regulation in Network industries, 20 November 2009, p.9

<sup>120</sup> ACCC, *Telstra's PSTN Originating Access exemption applications –CBD and Metropolitan areas*, Final Decision and Class Exemption, October 2008, p.190

<sup>121</sup> NBN Co, *NBN Corporate plan 2011-13*, 17 December 2010

Figure 3: NBN wholesale and retail business models



- 8.12 NBN Layer 2 wholesale services will be supplied on a regulated, non-discriminatory basis.<sup>122</sup> The ‘open access’ aspect of the network is confirmed by NBNC Co:

*As the NBN is an open-access wholesale network we will provide access to the network, and its connected customers, to any qualified retail service provider. We look forward to welcoming other RSPs as agreements are put in place.*<sup>123</sup>

- 8.13 Carriers will have the option to deal directly with NBN Co or use the services of a wholesaler or aggregator.
- 8.14 There will be regulated access to Layer 2 services offered by NBNC Co. NBNC Co has announced that it is proposing to lodge a Special Access Undertaking (SAU) with the ACCC under Part XIC of the CCA. It has stated that the SAU will cover key price and product aspects of access to NBN Co’s fibre, wireless and satellite networks including the descriptions of the Layer 2 wholesale services and products that NBN Co intends to supply.<sup>124</sup> Under s152CBA of the CCA, services supplied under the SAU will be treated as an active declared service, in other words the wholesale Layer 2 services supplied by NBNC Co will be treated as an active declared service. Or otherwise under s152AA of the CCA, a carriage service supplied by NBNC Co is a declared service if it has formulated a standard form of access agreement that relates to access to the service.
- 8.15 It is already clear that there will be a substantial number of RSPs taking wholesale services from NBNC Co. A number of service providers have already signed up with NBNC Co to take up wholesale Layer 2 services in Tasmania. In March 2010, the Government opened the Proof-of-Concept Test Centre in Tasmania and announced the first service providers (Primus, Internode and iiNet) to offer NBN services.<sup>125</sup> Telstra subsequently signed on with NBNC Co Tasmania as a service provider on 21 September 2010.<sup>126</sup> In April 2011, NBNC Co announced that 12 service providers have signed an agreement with NBNC Co to deliver services over the new network as part of its upcoming end-user trials across the five mainland release sites. The 12 service providers include Optus, AAPT, AARNet, Comcentre, Exetel, iiNet, Internode, iPrimus, Nextgen Networks, Platform Networks, SkyMesh and Telstra. In May 2011, NBN announced that the city of

<sup>122</sup> s152AXC of the Competition and Consumer Act

<sup>123</sup> NBN Co Limited, “NBN Co welcomes Telstra to Tasmanian network,” Media Release, 21 September 2010

<sup>124</sup> NBNC Co Limited, *Corporate Plan 2011-2013*, 17 December 2010, p.106

<sup>125</sup> Minister for Broadband, Communications and the Digital Economy, “First Tasmanian NBN retail service providers announced,” Press Release, 15 March 2010,

<sup>126</sup> NBN Co Limited, “NBN Co announces first service providers for mainland Australia,” Media Release, 8 April 2011

Armidale in NSW became the first centre to receive the NBN. Four service providers have completed the certification process including iiNet, Internode, iPrimus and Telstra.

- 8.16 Many of these service providers (including Telstra, Optus, Nextgen, AAPT and iPrimus) are presently wholesale suppliers. It is highly likely that most of these providers will continue to provide wholesale services in the NBN environment. For example, it appears likely that Telstra Wholesale will provide wholesale services in the NBN environment, given its public statement that:

*Integration with the NBN and the product features of Telstra Wholesale 2.0 is a huge priority, setting the foundations now for Telstra Wholesale to stay number one wholesaler in NBN Co world.*<sup>127</sup>

- 8.17 Optus has announced publicly that it will acquire NBN Layer 2 services both as a wholesaler and reseller. Optus Wholesale and Satellite Managing Director Vicki Brady has stated:

*...we are already well down the track in preparing for a future working with the NBN.*

*...Optus Wholesale will be there as an aggregator and reseller of NBN services.*<sup>128</sup>

- 8.18 The involvement of Optus as a wholesale supplier is a strong indication that the market will be effectively competitive, given Optus' proven track record of commitment to wholesale. Optus currently supplies fixed line services on a wholesale basis to a wide range of customers including significant market players such as **CiC**
- 8.19 The substantial number of providers also illustrates that the level of concentration in the wholesale market of Layer 2 service is unlikely to be high, which will place a competitive constraint on providers of NBN-based wholesale products.
- 8.20 On this basis, Optus submits that, based on the substantial number of wholesale providers and applying an equivalent rule of thumb to the one adopted by the ACCC in assessing Telstra's exemption applications, the market for NBN-based wholesale services should be considered effectively competitive.
- 8.21 Given that the market for supply of NBN-based wholesale services will be effectively competitive, Optus considers that to regulate both NBN wholesale Layer 2 services together with NBN based wholesale products will result in over-regulation and impose unnecessary costs.

### **Regulation in the transition period**

- 8.22 The ACCC also sought submissions on whether a transition period of regulation for these services will be necessary for voice providers to be able to interconnect with PSTN network as well as the NBN based network. Specially, the ACCC asked if there should be a time limit on the regulation of NBN-based wholesale services. For example, should such regulation be rolled back as competition develops, or as the roll-out of the NBN reaches completion.

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<sup>127</sup> Osborne, Glenn. "Straddling Both Worlds: A Telstra Wholesale Update", Speech, Comms Day Summit Sydney, 30 March 2011

<sup>128</sup> Brady, Vicky. "Managing Director Optus Wholesale and Satellite, A Wholesale Telco in a National Broadband Network World", Speech, Comms Day Summit Sydney, 29 March 2011

8.23 Optus submits that NBN based wholesale services should not be regulated, for the reasons discussed above. However, an exception to this general position relates to PSTN terminating access services which may be considered to have bottleneck characteristics. A transition period of regulation for terminating access services may therefore be necessary to ensure that voice providers are able to interconnect with the PSTN network as well as the NBN based network on reasonable terms.

#### **Pricing information relating to access to NBN-based wholesale services**

8.24 The ACCC also sought submission on whether the FAD should provide pricing information and other terms and conditions of access to NBN-based wholesale services. Again, Optus submits that NBN based wholesale services should not be regulated (subject to the above exception).

8.25 However if in the event the ACCC decides to regulate NBN-based wholesale services, Optus submits that the ACCC should defer setting terms and conditions of access until after it has finalised the regulated terms and conditions for access to NBN Layer 2 wholesale services, since the access terms applying to NBN Layer 2 wholesale services (such as the pricing) will have major implications for the access terms of NBN-based wholesale services.

## Section 9. Fixed Principles Provisions

- 9.1 The ACCC has proposed to make 'fixed principles provisions' for the declared fixed line services which are intended to endure beyond the expiry date for the FADs.
- 9.2 While the ACCC has recognised that *"it has not previously consulted explicitly on making fixed principles provisions,"*<sup>129</sup> it considers that doing so will:
- (a) Provide certainty on how prices are to be estimated over the course of the proposed regulatory period, and any future periods prior to the 'notional termination date';
  - (b) Reduce regulatory burden and time required to conduct price resets; and
  - (c) Promote price stability, for example, by locking-in the initial RAB used in the FLSM for estimating prices.
- 9.3 Optus advocates a cautious approach with regard to fixed principles provisions. The ACCC is establishing a new regime which is as yet untested. Given the potential for a prolonged length of applicability, Optus considers that it would be prudent to observe the operation of the regime in its initial stages before 'setting in stone' any principles or rules.
- 9.4 Optus notes that a number of the proposed principles were identified in the ACCC's September 2010 Draft Report,<sup>130</sup> on which stakeholders were given an opportunity to comment. However, Optus is concerned that while the specific BBM-related provisions to be included as fixed principles may be similar at a high level to those previously consulted on, some of the underlying principles have not been sufficiently scrutinised. In particular, the Working Proposal set out by Telstra in its last submission has not been sufficiently scrutinised. A discussion of some of these comments is set out in Appendix H.
- 9.5 Optus considers that the short duration of the current consultation period is disproportionate to the length of the period for which these fixed principles provisions will be locked-in. The ACCC has set a notional termination date of 30 June 2021 for the application of these fixed principles provisions.
- 9.6 Optus submits that the ACCC should not set comprehensive fixed principles provisions in the current consultation as it has proposed. Rather, the ACCC should make only a bare minimum number of fixed principles now. For example it could make a fixed principles provision to specify the method of estimating prices using a BBM approach.
- 9.7 Rather, the ACCC should reserve its right to set the remaining fixed principles provisions for each of the BBM-specific parameters at a later date and subject to a separate review. One opportunity would be to consult on fixed principles in parallel with the re-declaration inquiry prior to 2014. Holding a separate consultation at a later date would provide interested parties with adequate time in which to give due consideration to these important matters.

<sup>129</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion Paper, April 2011, p.252

<sup>130</sup> ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010

## List of Appendices

**Appendix A: Calculation of ULLS price using alternative weighting methods**

**Appendix B: New DSLAM investment [CiC]**

**Appendix C: PSTN OTA international benchmarking**

**Appendix D: Business benefits of moving to a uniform PSTN OTA price [CiC]**

**Appendix E: Impact of geographical exemptions in the corporate and government market [CiC]**

**Appendix F: Cost allocation**

**Appendix G: Non-price terms**

**Appendix H: Fixed principles**

## List of Attachments

**Attachment 1: CEG Report: PSTN OTA Rate Structures**