Before the

AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

In the Matter of	)
Assessment of Telstra's Unconditioned Local Loop Service Monthly Charge Undertakings	)

ASSESSMENT OF FRONTIER ECONOMICS' REPORT ON TELSTRA'S ULLS UNDERTAKING BY DAVID E. M. SAPPINGTON

1. I have been asked by Telstra to assess the report submitted to the Australian Competition and Consumer Commission by Frontier Economics.[1] This report, commissioned by Optus, is intended to assess the impact of geographically averaged ("uniform") ULLS prices on the promotion of competition in Australia.

2. In my opinion, the Frontier report sheds little light on this important issue because it fails to consider the key industry conditions that constitute the rationale for uniform ULLS prices. Instead, the report relies upon standard economic models of competition between unregulated firms. Such models do not adequately reflect the relevant conditions in Australia's telecommunications industry. Consequently, these models preclude a comprehensive, objective assessment of the merits of uniform ULLS prices.

3. The Frontier report notes that uniform ULLS prices will increase the costs of ULLS-based competitors above the costs they would incur in urban regions of Australia if cost-based (geographically de-averaged) ULLS prices were implemented. The report then employs the aforementioned standard economic models of unregulated competition to offer predictions about the extent to which urban customers will face higher prices for telecommunications services if uniform ULLS prices are adopted.

4. The analysis in the Frontier report abstracts entirely from the regulations under which Telstra operates. Telstra presently operates under price cap regulation, and therefore does not

[1] Frontier Economics, *Telstra's ULLS Undertaking – Impact of Average ULLS Charges on Promotion of Competition*: *A Report Prepared for Optus*, July 2006 ("Frontier report").

have unrestricted freedom to raise the prices it charges for its services in the urban regions of Australia. Consequently, the models of unregulated competition employed in the Frontier report are not appropriate for assessing the effects of cost changes on retail prices in Australia's telecommunications industry.

5. The Frontier report also abstracts entirely from the uniform retail price mandate that is imposed asymmetrically on Telstra. This mandate requires Telstra to charge the same price for unbundled basic access service throughout Australia.[2] The textbook models of price competition employed in the Frontier report consider a single product sold in a single geographic market at a single point in time. Consequently, these models are not designed to assess either the short-term effects or the long-term effects of the uniform retail price mandate.

6. The uniform retail price mandate limits Telstra's incentive to reduce the price it charges for unbundled basic access service in urban regions of Australia. The reduced incentive arises because any such price reduction requires a corresponding reduction in the price of unbundled basic access service throughout Australia. Consequently, any reduction in urban competitors' costs that might arise from geographically de-averaged ULLS prices will not necessarily reduce retail prices to the extent predicted by standard economic models of unregulated competition. Instead, the cost reductions could serve largely to inflate the profits of Telstra's urban competitors and facilitate the operation of inefficient competitors.

7. The Frontier report also fails to assess the cream-skimming that the uniform retail price mandate encourages. When the mandate serves to hold retail prices below cost in rural regions of Australia, Telstra must set prices above cost in urban regions in order to earn a normal (competitive) return on its overall operations. Above-cost prices attract selective entry (i.e., cream-skimming) by competitors – even inefficient competitors – in urban regions of Australia. The operation of inefficient competitors raises industry costs and wastes valuable social resources.

8. The static analysis in the Frontier report fails to consider the long-term consequences of the cream-skimming that geographically de-averaged ULLS prices can promote. By reducing the

[2] "Telstra must offer basic line rental services to residential and charity customers, in non-metropolitan areas, at the same or a lower price and on the same price-related terms as it offers to residential and charity customers in metropolitan areas." Also, "Telstra must offer basic line rental services to business customers, in non-metropolitan areas, at the same or a lower price and on the same price-related terms as it offers to business customers in metropolitan areas." *Telstra Carrier Charges – Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2005 (Amendment No. 1 of 2006),* § 19A(1),(2).

number of urban customers that Telstra serves, cream-skimming can serve to increase Telstra's unit production costs and jeopardize Telstra's ability to finance low prices in rural regions of Australia.[3] Consequently, to ensure that Telstra can continue to attract the capital it requires to provide high-quality service to its customers, the price that Telstra is permitted to charge for unbundled basic access service in rural regions would have to be increased to offset the effects of cream-skimming. Failure to implement such a price increase (or other compensatory policy) would be contrary both to Telstra's "legitimate business interests" and to "the long-term interests of end-users," as such failure would jeopardize the long-term supply of high-quality services to rural customers.[4]

9. By focusing on the effects of price competition in urban regions without considering the long-term ramifications for prices in rural regions of Australia, the Frontier report fails to provide a comprehensive, objective assessment of uniform ULLS prices on "the long-term interests of end-users" of telecommunications services in Australia.[5] By failing to differentiate between regulatory arbitrage in the form of cream-skimming and competition based upon relative efficiencies, the Frontier report also fails to provide a comprehensive, objective assessment of the extent to which geographically de-averaged ULLS prices serve "the objective of promoting competition" in Australia's telecommunications industry.[6]

10. The Frontier report notes that geographically de-averaged ULLS prices have been implemented in some other countries. This fact is not surprising, given that all countries do not impose on their incumbent suppliers of telecommunications services uniform retail price mandates like the one that Australia imposes upon Telstra. Geographically de-averaged ULLS prices can be appropriate in the absence of a uniform retail price mandate. However, uniform

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[3] In theory, the Universal Service Regime could be employed to finance low prices for telecommunications services in rural regions of Australia. In practice, it is far from apparent that the Universal Service Regime serves this purpose. See, for example, the Statement of Geoffrey David Sims (*In the Matter of Undertakings Dated 23 December 2005 Provided by Telstra Corporation Limited to the Australian Competition and Consumer Commission in Respect of Unconditioned Local Loop Service*, 21 July 2006).

[4] Section 152 AH of the *Trade Practices Act* 1974 ("**the Act**"). The detrimental role that geographically de-averaged ULLS prices can play in promoting cream-skimming and undermining the uniform retail price mandate is explained in more detail in the *Expert Report of David E. M. Sappington on the Merits of Uniform ULLS Prices*, submitted to the Australian Competition and Consumer Commission, 28 July 2006.

[5] Section 152 AH of the Act.

[6] Section 152 AB of the Act.

ULLS prices are appropriate in the presence of such a mandate. As the Organization for Economic Co-operation and Development concludes:

> "… the structure of access charges should reflect the structure of the end-user charges. If end-user prices are geographically averaged, and ULL [unbundled local loop] charges are based on actual costs, the entrants will have a strong incentive to only request unbundled local loops in low-cost areas, intensifying competition in those regions and driving down retail prices in those areas, raising prices in other areas. ... [I]f the regulator wishes to preserve the geographically-averaged structure of end-user prices, it is essential to geographically average ULL prices."[7]

11. In summary, the Frontier report employs inappropriate economic models and fails to analyze the regulations that are imposed asymmetrically on Telstra in Australia. Consequently, it is not surprising that the Frontier report fails to appreciate the important role that uniform ULLS prices can play in limiting cream-skimming and supporting the uniform retail price mandate, thereby helping to ensure the continued supply of key telecommunications services at low prices in rural regions of Australia.[8]

DAVID E. M. SAPPINGTON
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[7] Organization for Economic Co-operation and Development. *Access Pricing in Telecommunications*. Paris: OECD, 2004, p. 134.

[8] It is also not surprising that Optus endorses the observations in the Frontier report, since geographically de-averaged ULLS prices will facilitate cream-skimming by Optus and other competitors. Optus notes that the "comments [in the Frontier report] are consistent with the arguments Optus has made" (*Optus Submission on ACCC Draft decision on ULLS Monthly Charge Undertaking* [*Confidential Version*], July 2006, ¶ 4.3).