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**AUSTRALIAN COMPETITION AND CONSUMER COMMISSION**

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**EXPERT REPORT OF DAVID E. M. SAPPINGTON ON**

**ULLS-SPECIFIC COST AND PAYMENT RECONCILIATION**

Qualifications.

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**QUALIFICATIONS**

1.    My name is David Sappington. I am the Lanzillotti-McKethan Eminent Scholar in the Warrington College of Business at the University of Florida. I am also the Director of the University's Public Policy Research Center.

2.    I earned my Ph.D. in Economics from Princeton University in 1980.  Since that time, I have served as a full-time faculty member at the University of Michigan, the University of Pennsylvania, and the University of Florida.  I have also served as a visiting lecturer with the title of full professor at Princeton University.

3.    Between 1984 and 1989, I was a member of the professional staff of Bell Communications Research (Bellcore). I was promoted to the rank of District Manager at Bellcore in 1989, before leaving to join the faculty of the University of Florida.

4.    In 2001 and 2002, I served as the Chief Economist of the U.S. Federal Communications Commission. As Chief Economist, I assumed primary responsibility for all economic matters that came before the Commission.

5.    My research focuses on the design of regulatory policy in the telecommunications industry.  This research has culminated in more than one hundred articles and a book entitled *Designing Incentive Regulation for the Telecommunications Industry*. My work has been published in leading economics and law journals, including the *American Economic Review*, the *Journal of Political Economy*, the *Rand Journal of Economics*, the *Journal of Regulatory Economics*, and the *University of Chicago Law Review*.

6.    I presently serve on the editorial boards of five leading economics journals, including the *Rand Journal of Economics*, the *Journal of Regulatory Economics*, and the *Journal of Economics and Management Strategy*.  I have also served on the editorial boards of other major journals, including the *American Economic Review* and the *Journal of Industrial Economics*.  I am also the Vice President and President-Elect of the International Industrial Organization Society.

7.    In addition to my academic research, I have provided expert advice to many corporations, including BellSouth, GTE, SBC, TELUS, and UPS. I have also advised several regulatory bodies, including the New York State Public Service Commission and CONATEL and OSIPTEL, the national telecommunications regulatory agencies in Ecuador and Peru, respectively. In addition, I have served as an advisor on competition policy in the communications industry for the Antitrust Division of the U. S. Department of Justice.

8.     In advising corporations and regulatory agencies, I routinely analyze complex issues related to the design of regulation policy in the presence of industry competition.  I also analyze such issues in my research and in my service on editorial boards, just as I did on a daily basis during my tenure as chief economist at the U.S. Federal Communications Commission.

9.     My curriculum vita is attached as Appendix A to this report.

## INTRODUCTION AND OVERVIEW

10.     I have been asked by Telstra Corporation Ltd. ("**Telstra**") to provide my expert opinion on the merits of implementing a policy that helps to ensure a closer matching of the payments for and the cost of supplying the unconditioned local loop service ("**ULLS**"). In my view, such a policy is a reasonable one that provides important gains to Telstra and to users of ULLS alike. Therefore, I recommend the implementation of such a "reconciliation policy."

11.     I present and support my recommendation as follows. First, I review briefly how payments for ULLS-specific costs presently are determined.[1] Second, I explain why the present policy imposes substantial risk of excessive or incomplete recovery of relevant ULLS-specific costs on ULLS users and Telstra alike. Third, I show how a simple reconciliation policy that is readily implemented can reduce this risk considerably and thereby benefit both ULLS users and Telstra. Fourth, I note that any increased ULLS charges that might result from a reconciliation policy in one recovery period are likely to be offset by reduced ULLS charges in other recovery periods. Fifth, I explain how a reconciliation policy can help to secure more accurate forecasts of ULLS usage, and thereby reduce the need for ongoing reconciliation. I conclude by emphasizing that reconciliation is a simple, reasonable, balanced policy that promotes "the long-term interests of end-users" and is sensitive both to "the interests of persons who have rights to use the declared service" (ULLS users in particular) and to Telstra's "legitimate business interests."[2]

12.     My recommendation to implement a reconciliation policy reflects the following five observations, which I understand to be true.  First, Telstra incurred ULLS-specific costs to fulfill its obligation to provide ULLS. Second, the Australian Competition and Consumer Commission ("**ACCC**") established a ULLS charge that was intended to allow Telstra to recover between 2000 and 2005 the relevant ULLS-specific costs. Third, in part because the realized demand for ULLS during

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[1]     ULLS-specific costs are costs that Telstra would not incur if it did not produce ULLS.

[2]     Section 152AH of the *Trade Practices Act* ("**the Act**").

this period was less than the forecast demand, Telstra did not recover all of the relevant costs between 2000 and 2005. Fourth, Telstra originally forecast a smaller demand for ULLS than the forecast the ACCC employed to set the relevant ULLS charge. Fifth, no formal policy was originally stated regarding the actions that would be taken if Telstra recovered either more or less than the relevant costs between 2000 and 2005.

13.     The present question is whether Telstra should be permitted to recover some or all of the realized "cost shortfall", i.e., the relevant ULLS-specific costs that Telstra did not recover between 2000 and 2005. I now proceed to explain why such recovery is warranted in the context of a reconciliation policy that facilitates an ongoing alignment of future ULLS-specific costs and payments.[3]

## I.     THE ABSENCE OF RECONCILIATION CAUSES UNDUE RISK OF EXCESSIVE OR INSUFFICIENT COST RECOVERY

### A.     ULLS CHARGES REFLECT IMPERFECT DEMAND FORECASTS

14.     The arrangement that has been employed to recover ULLS-specific costs in Australia can be described in the simplest of terms as follows.[4] First, the relevant ULLS-specific costs were identified. Second, the demand for ULLS during the "recovery period" (2000 – 2005) was forecast. Third, a constant per-line ULLS charge equal to the ratio of the identified costs to the forecast demand was specified. This charge was intended to generate payments by ULLS users to Telstra during the recovery period equal in magnitude to the relevant ULLS-specific cost.

15.     This constant charge imposed on ULLS users would generate payments exactly equal to the relevant ULLS-specific costs if the actual, realized demand for ULLS during the recovery period coincided with the forecast of ULLS demand that was employed to set the ULLS charge. However, if the actual demand for ULLS during the recovery period were less than the forecast demand, ULLS users would pay Telstra less than the relevant ULLS-specific costs. Conversely, if actual demand for ULLS during the recovery period exceeded the demand forecast, ULLS users would pay Telstra more than the relevant ULLS-specific costs.

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[3]   I do not attempt to quantify the magnitude of the difference between relevant ULLS-specific costs and payments. My focus is on the importance of limiting this difference and explaining how to do so.

[4]   For simplicity, the following description abstracts from calculations that were employed to account for the time value of money and for the fact that all relevant ULLS-specific costs were not recovered immediately after they were incurred.

16.     These conclusions are readily demonstrated using some simple arithmetic. Let $C$ denote the relevant ULLS-specific costs. Also let $D^F$ and $D^A$, respectively, denote the forecast and the actual demand for ULLS during the recovery period.  As explained above, the ULLS charge imposed during the recovery period is the ratio of the relevant costs to the forecast demand ($C/D^F$). The payments generated by this charge during the recovery period are $D^A[C/D^F]$, the product of the charge and the actual demand for ULLS during the recovery period.

17.     Notice that:

$$\text{ULLS Payments} \; = \; D^A\left[\frac{C}{D^F}\right] \; = \; \left[\frac{D^A}{D^F}\right]C. \tag{1}$$

18.     Equation (1) demonstrates the conclusions stated above. ULLS users pay exactly the relevant ULLS-specific costs ($C$) only if the initial forecast of ULLS demand is a perfect forecast (so $D^F = D^A$, in which case $D^A/D^F = 1$). If the initial forecast exceeds the actual demand (so $D^F > D^A$ and therefore $D^A/D^F < 1$), ULLS users end up paying less than the relevant ULLS-specific costs. If the initial forecast is less than the actual demand (so $D^F < D^A$ and therefore $D^A/D^F > 1$), ULLS users end up paying more than the relevant ULLS-specific costs.

B.      THE ABSENCE OF RECONCILIATION IMPOSES RISK ON ULLS USERS AND TELSTRA ALIKE

19.     Although this simple description of the prevailing arrangement to recover ULLS-specific costs abstracts from some detail, it captures the essence of the arrangement and highlights the central drawback to the arrangement. The arrangement introduces substantial risk of excessive or incomplete recovery of relevant ULLS-specific costs. This risk is borne by ULLS users and Telstra alike.  Only if demand for ULLS is forecast perfectly will ULLS users pay Telstra exactly the relevant ULLS-specific costs. If the demand for ULLS is over-estimated, ULLS users pay less and Telstra receives less than the relevant ULLS-specific costs. In this case, Telstra's customers and/or its shareholders are required to bear costs that support the operation of Telstra's competitors. This outcome is inconsistent with the long-term interests of Telstra's customers and with Telstra's legitimate business interests. If the demand for ULLS is under-estimated, ULLS users pay more and Telstra receives more than the relevant ULLS-specific costs. In the absence of good reasons to tax the operations of competitors, this outcome is inconsistent with the legitimate business interests of competitors that use ULLS and with the long-term interests of their customers.

20.    These drawbacks to the present arrangement for recovering ULLS-specific costs do not imply that the arrangement is entirely without merit. Competitors benefit from the certainty provided by a ULLS charge that does not vary during the recovery period. In order to set a charge that: (i) does not vary within the recovery period; and (ii) is likely to recover the relevant ULLS-specific costs reasonably accurately, one must rely on an estimate of the demand for ULLS, since actual demand cannot be known until the end of the period. Therefore, the present arrangement is well-intentioned, and could constitute a reasonable policy if accurate long-term forecasts of ULLS demand were available and were employed to set ULLS charges.

21.    In practice, demand can be very difficult to forecast accurately even for established services in mature industries. Demand can be particularly difficult to forecast accurately when the service in question, like ULLS, is a relatively new service in a dynamic industry. Table 1 illustrates the difficulty the ACCC encountered in specifying an accurate forecast of ULLS demand. The table contrasts forecast and actual ULLS demand for the 2003/04 and 2004/05 time periods. The second column in Table 1 presents Telstra's February 2003 estimate of ULLS demand.[5] The third column in Table 1 records the corresponding estimate adopted by the ACCC in October 2003.[6] Actual ULLS demand is presented in the fourth column of Table 1.[7]

| Year | Telstra's February 2003 ULLS Demand Estimate | ACCC's October 2003 ULLS Demand Estimate | Actual ULLS Demand |
|---|---|---|---|
| | | | |
| 2003/04 | c-i-c | c-i-c | c-i-c |
| 2004/05 | c-i-c | c-i-c | c-i-c |

**Table 1.    Estimated and Actual ULLS Demand.**

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[5]    *Telstra's Submission in Relation to the Methodology used for Deriving Prices Proposed in its Undertakings dated 9 January 2003*, Annexure N, 13 February 2003.

[6]    ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p. 83.

[7]    *Confidential Statement of Ashwini Pradhan*, Annexure B, submitted to the ACCC 26 July 2006.

22.    Two features of Table 1 warrant emphasis. First, forecast ULLS demand can vary substantially from actual ULLS demand in practice. Second, Telstra's forecast of ULLS demand for these time periods was more accurate than the forecast the ACCC employed to set ULLS prices.

23.    It may ultimately be possible for the ACCC to specify more accurate forecasts of ULLS demand when setting ULLS prices, but perhaps not until considerable experience with ULLS admits a better understanding of the determinants of ULLS demand. Until the regulatory process can be relied upon to produce far more accurate ULLS demand forecasts, a more reliable way to limit the risk of excessive or incomplete recovery of relevant ULLS-specific costs would benefit ULLS users and Telstra alike.[8]

**II.    A SIMPLE RECONCILIATION POLICY CAN LIMIT RISK FOR ULLS USERS AND TELSTRA ALIKE**

24.    Fortunately, there is a simple "reconciliation" policy that can limit substantially the risk of excessive or incomplete recovery of ULLS-specific costs. The policy simply records the actual, realized amount of under-recovery or over-recovery that occurs during the initial recovery period (2000 – 2005 in the present instance). Then the ULLS charge is adjusted in the subsequent recovery period to offset the realized excessive or incomplete recovery in the initial period.

A.    RECONCILIATION LIMITS UNDER-RECOVERY OF COSTS

25.    The following simple example illustrates how a reconciliation policy would work more generally. Suppose the relevant ULLS-specific costs that Telstra is authorized to recover in an initial period are $100. Also suppose ULLS demand is forecast to be 50 during this period, but actual demand during the period turns out to be 40.

26.    Following the procedure presently employed in Australia, the ULLS charge for the initial period in the example could be set at $2 (= $100/50), which is the ratio of the relevant ULLS-specific costs to the forecast demand for ULLS. This charge will recover the $100 ULLS-specific costs exactly if actual demand coincides with the forecast demand (50). Because the actual demand for ULLS in the initial period in this example is only 40, though, total payments by ULLS users are only $80 (= $2 x 40). If no reconciliation were admitted, the ultimate outcome in this example would be that Telstra receives only $80 of the $100 in relevant ULLS-specific costs.

27.    Even the simplest of reconciliation policies can help to avoid such substantial under-recovery of relevant ULLS-specific costs. To illustrate how a simple reconciliation policy would operate in the

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[8]    A more reliable means of limiting this risk is faithful to the requirement to consider "the risks involved in making the investment" when assessing incentives for infrastructure investment (section 152AB of the Act).

context of the example under consideration, consider the following extension of the example. Suppose an additional $100 in new ULLS-specific costs is authorized for recovery in a second recovery period (e.g., 2006 – 2008). Further suppose ULLS demand is again forecast to be 50, but actual demand is 40 during this second recovery period.

28.    Absent reconciliation, the $20 under-recovery of ULLS-specific costs in the initial recovery period would be ignored, and the ULLS charge for the second recovery period would again be set at $2 (= $100/50) to recover the new ULLS-specific costs in expectation (i.e., based upon the forecast demand). Under the reconciliation policy, the ULLS charge in the second period would be increased by an amount that recovers the first-period under-recovery ($20) in expectation. Specifically, the second-period ULLS charge would be increased by $.40, from $2 to $2.40. This $.40 (= $20/50) increase is the ratio of the first-period under-recovery ($20) to the forecast second period demand (50). This increase in the second-period ULLS charge would permit full recovery in the second period of the initial $20 under-payment if the second-period demand forecast (50) were accurate. In the example, the forecast over-estimates actual second-period demand for ULLS (40), and so only $16 (= $.40 x 40) of the initial $20 first-period under-payment is recovered in the second period.

29.    Thus, in this example, the reconciliation policy allows for substantial (80% = 16/20), but not complete, recovery of the initial under-payment of ULLS-specific costs. To achieve more complete reconciliation, corresponding provisions could be implemented that permit recovery of the residual under-recovery ($4 = $20 – $16) in future periods.

B.    RECONCILIATION LIMITS OVER-RECOVERY OF COSTS

30.    In the foregoing example, the simple reconciliation policy limits the incomplete recovery of relevant ULLS-specific costs that arises because demand initially is over-estimated. The same policy also limits the excessive recovery of relevant ULLS-specific costs that arises when ULLS demand initially is under-estimated. To illustrate this important feature of the reconciliation policy, suppose everything is as specified in the foregoing example with one exception. Suppose ULLS demand is forecast to be 40 in each of the two recovery periods, but ultimately turns out to be 50 in each period. In this setting, the ULLS charge in the initial recovery period will be $2.50 (= $100/40), which is the ratio of the relevant ULLS-specific costs to the forecast first-period ULLS demand. Total payments by ULLS users in the first period will be $125 (= $2.50 x 50), which is the product of the ULLS charge

and actual first-period ULLS demand. Thus, ULLS users will have paid $25 more than the relevant ULLS-specific costs ($100).

31.    To correct for this $25 over-payment, the reconciliation policy reduces the second-period ULLS charge by $.625 (= $25/40), which is the ratio of the over-payment to the forecast demand. The total reduction in second-period ULLS payments introduced by the reconciliation policy is $31.25 (= $.625 x 50), which is the product of the reduction in the ULLS charge and the actual demand for ULLS during the second recovery period. Notice that the persistent under-estimate of ULLS demand in this example ensures that ULLS users are more than compensated for their initial over-payment. The second-period "credit" of $31.25 exceeds the initial over-payment of $25. On balance, the reconciliation policy results in ULLS users under-paying for first-period ULLS-specific costs by $6.25 rather than overpaying by $25.

C.    RECONCILIATION IS READILY IMPLEMENTED

32.    As the foregoing examples illustrate, the recommended reconciliation policy is a simple policy that is readily implemented.[9] The only additional information required to implement the policy (relative to the information required to implement the prevailing arrangement for recovering relevant ULLS-specific costs) is the realized demand for ULLS during each recovery period. This information is readily available in Telstra's records at the end of each recovery period. Therefore, the reconciliation policy requires virtually no new information to implement, and yet promises substantial reduction in the risk of excessive or incomplete recovery of relevant ULLS-specific costs. By reducing this risk, the reconciliation policy can help to promote "economically efficient investment in the [telecommunications] infrastructure" in Australia without introducing significant administrative difficulty or cost.[10]

D.    RECONCILIATION CAN FACILITATE MORE ACCURATE DEMAND FORECASTS

33.    The adoption of a reconciliation policy also can help to secure more accurate forecasts of ULLS demand. Consequently, the adoption of a reconciliation policy can limit initial excessive or incomplete

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[9]    Notice that this reconciliation policy is very similar in spirit to the unders and overs accounts that are employed in the Australian electricity and rail industries.

[10]   Section 152AB of the Act.

recovery of relevant ULLS-specific costs, and can thereby reduce the amount of reconciliation of payments and costs that ultimately is necessary.

34.    To understand why the adoption of a reconciliation policy can help to secure more accurate forecasts of ULLS demand, consider the gains that biased demand forecasts can produce when a reconciliation policy is not employed. As is evident from equation (1) above, ULLS users gain if the demand forecast ($D^F$) used to construct ULLS charges overstates actual demand ($D^A$). The over-estimate of demand produces a ULLS charge that is unduly low, and thereby generates ULLS payments that are less than relevant ULLS-specific costs. In contrast, Telstra gains if the demand forecast used to set ULLS charges understates actual demand. The under-estimate results in a ULLS charge that is unduly high, and thereby generates ULLS payments that exceed the relevant ULLS-specific costs.

35.    The discrepancies between relevant ULLS-specific costs and corresponding payments from ULLS charges that result from imperfect demand forecasts can be pronounced. If the forecast ULLS demand exceeds actual demand by 20%, for example, ULLS payments will cover only 83% of the relevant ULLS-specific costs.[11] If the forecast ULLS demand is 20% less than actual demand, ULLS payments will be 25% greater than actual ULLS-specific costs.[12] These under-recoveries and over-recoveries of relevant ULLS-specific costs are not unrealistic, and can be very large in nominal terms given that ULLS-specific costs can constitute many millions of dollars.

36.    The large sums of money at stake when no reconciliation policy is implemented can provide ULLS users with considerable incentive to err on the side of over-estimating ULLS demand and Telstra with considerable incentive to err on the side of under-estimating ULLS demand. These incentives can be mitigated substantially even by the simple reconciliation policy described above. When any initial under-recovery or over-recovery of relevant ULLS-specific costs is largely reversed in the subsequent recovery period, the potential gains from having a favorable ULLS demand forecast employed to calculate ULLS charges in the initial period is diminished substantially.[13] Therefore, the

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[11]   If forecast demand ($D^F$) exceeds actual demand ($D^A$) by 20%, then $D^F = 1.2\,D^A$. Consequently, $D^A / D^F$ = $1/1.2$ = .83.

[12]   If forecast demand ($D^F$) is 20% less than actual demand ($D^A$), then $D^F = .8\,D^A$. Consequently, $D^A / D^F$ = $1/.8 = 1.25$.

[13]   These gains generally will not be eliminated entirely if the recovery of over-payments or under-payments is limited to a single subsequent recovery period. To further diminish the gains from the adoption of a favorable demand forecast, additional reconciliation periods can be employed without considerable increase in

adoption of a reconciliation policy can help to secure less contentious regulatory proceedings and more objective, more accurate forecasts of ULLS demand. More accurate forecasts will limit the amount of reconciliation of ULLS-specific costs and payments that ultimately is necessary.

E.    INTERTEMPORAL VARIATIONS IN ULLS CHARGES DUE TO RECONCILIATION ARE OFFSETTING

37.    The implementation of a reconciliation policy can cause the prevailing ULLS price in a subsequent recovery period to be higher than it otherwise would be. ULLS users might express concerns about this feature of a reconciliation policy. Two observations are important in this regard. First, ULLS prices will be higher in a subsequent period precisely when they failed to recover relevant ULLS-specific costs in an earlier period. Therefore, any higher prices that arise in subsequent recovery periods are reasonably viewed as corrections for earlier prices that were unduly low. Second, any price increase that results from reconciliation in one recovery period will tend to be offset by price decreases in other recovery periods. Reconciliation would only produce a systematic increase in ULLS prices if demand for ULLS were systematically and repeatedly over-estimated. There is no reason for ongoing, systematic over-estimation of ULLS demand.[14]

## III.    RECONCILIATION IS A REASONABLE, BALANCED POLICY THAT WARRANTS IMPLEMENTATION

38.    When policies are not fully specified in advance and the time comes to specify the policy fully, it is appropriate to implement a reasonable, balanced policy that offers long term advantages for all parties. The implementation of such a policy is consistent with the ACCC's mandate to promote "the long-term interests of end-users" while considering "the interests of persons who have rights to use the declared service" (ULLS users in particular) and to Telstra's "legitimate business interests" alike.[15] The policy respects Telstra's "legitimate business interests" by helping to ensure that Telstra recovers the efficient ULLS-specific costs it incurs on behalf of ULLS users. The policy protects "the interests of persons who have rights to use the declared service" by reducing the risk of over-payment or under-payment of relevant costs that ULLS users face. The policy serves "the long-term interests of end-

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complexity. Accurate forecasts can be further encouraged by affording greater weight in future proceedings to the demand forecasts of parties whose forecasts in past proceedings have proved to be particularly accurate.

[14]    Furthermore, as noted immediately above, if ULLS demand were systematically over-estimated on an ongoing basis, the higher ULLS charges in subsequent periods would help to correct the systematic under-payment of relevant ULLS-specific costs in earlier periods.

[15]    Section 152AH of the Act.

users" by "encouraging the economically efficient use of … the [telecommunications] infrastructure."[16] Efficient use of the infrastructure is encouraged when ULLS users face charges that more closely reflect the costs of accessing Telstra's network.

39.    Some might contend that implementation of reconciliation at a time when its absence would provide short term gains to ULLS users is contrary to the interests of ULLS users. However, this contention ignores two important facts. First, the absence of reconciliation imposes short term costs on Telstra. If reconciliation were not implemented, Telstra would not be compensated for relevant ULLS-specific costs that were incurred to assist the operations of ULLS users. Second, such under-payment of ULLS costs can arise in the absence of any error or inappropriate behavior on Telstra's part. The present underpayment reflects in large part the over-estimate of ULLS demand the ACCC employed to calculate the relevant ULLS price. As Table 1 suggests, the present under-payment would have been substantially smaller if Telstra's demand forecast had been employed to calculate the ULLS price.[17]

40.    The ACCC suggests that "including historic profits or losses would shift all risk of demand forecasts onto access seekers."[18] In fact, a reconciliation policy of the type described above limits the risk of over-payment or under-payment of relevant charges that access seekers face. In the absence of a reconciliation policy, unavoidable errors in forecasting demand can force access seekers to pay substantially more or substantially less than the intended charges. In contrast, a reconciliation policy can reduce considerably the magnitude of such over-payment or under-payment, and thereby reduce the associated risk for access seekers.

41.    A reconciliation policy also can benefit access seekers by reducing Telstra's cost of capital in supplying ULLS. This capital cost is reduced by a reconciliation policy that reduces the uncertainty Telstra faces regarding the fraction of ULLS-specific costs it will recover from ULLS users. Thus, the adoption of a reconciliation policy can reduce the costs that access seekers are legitimately required to bear.

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[16]    Section 152AB of the Act.

[17]    Notice that the present regulated outcome is fundamentally different from the outcome in an unregulated commercial relationship where a supplier agrees to recover costs in the form of a usage charge. In the unregulated setting, the supplier presumably would base the usage charge on its own estimate of demand rather than on a demand estimate imposed by a regulator. Consequently, if the supplier suffered a financial loss because it over-estimated demand in the unregulated commercial relationship, the loss would stem from the supplier's own imperfect forecast. In the present regulated setting, the loss Telstra stands to bear in the absence of a reconciliation policy reflects in large part an over-estimate of demand imposed by the ACCC.

[18]    ACCC, *Assessment of Telstra's ULLS Monthly Charge Undertakings*, Confidential Draft Decision, June 2006, Appendix E.3.3, p. 84.

42.    In short, reconciliation is a reasonable, balanced policy that serves the long-term interests of all parties. Furthermore, a simple reconciliation policy of the type described above requires only a single, elementary calculation and virtually no new information to implement. The immediate implementation of such a policy will ensure that ULLS users and Telstra alike can begin to benefit from its many advantages right away. Implementing a reconciliation policy now also will help to avoid an under-payment of relevant ULLS-specific costs that has arisen because ULLS demand was over-estimated.

## IV.    RECONCILIATION IS SUPERIOR TO ALTERNATIVE PROPOSALS

43.    Optus laments the fact that there presently "is no mechanism in the undertaking to prevent over-recovery of costs",[19] and proposes a "tiered pricing structure" to prevent Telstra from "simply pocketing any windfall gain."[20] The reconciliation procedure described above achieves this purpose while avoiding "the complexity of rebates to be applied to access seekers" that Optus concedes will arise under its plan.[21]

44.    Optus also states that "there needs to be an objective means of setting demand forecasts."[22] For the reasons discussed above, the reconciliation procedure improves the incentives of all parties to provide objective, accurate demand forecasts.

45.    The reconciliation procedure described above also limits the "strong incentives [for Telstra] to understate demand" that Optus identifies.[23] (Optus declines to discuss the corresponding incentives to exaggerate demand by ULLS users and others who might gain as Telstra is saddled with ULLS-specific costs. However, the reconciliation procedure described above mitigates these inappropriate incentives also.) By limiting "distortions" and providing "correct incentives",[24] the reconciliation procedure obviates any need to "allocate ULLS-specific costs across the entire fixed telephony base" simply because ULLS demand is difficult to predict.[25] The reconciliation procedure recognizes the difficulties in forecasting demand accurately, and explicitly accounts for these difficulties. The

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[19]    *Optus Submission to Australian Competition and Consumer Commission on Telstra's ULLS Undertakings (Public Version)*, March 2006 [*Optus Submission*], ¶ 5.49.

[20]    *Ibid*, ¶ 5.54.

[21]    *Ibid*, ¶ 5.54.

[22]    *Ibid*, ¶ 5.51.

[23]    *Ibid*, ¶ 5.57.

[24]    *Ibid*, ¶ 5.49.

[25]    *Ibid*, ¶ 5.50.

procedure addresses directly Optus' call for "a mechanism to prevent Telstra over recovering its costs."[26]

## SUMMARY AND CONCLUSIONS

46.    In summary, I recommend the immediate adoption of a reasonable, balanced reconciliation policy like the one described above. Such a policy limits substantially the risk of excessive or incomplete recovery of relevant ULLS-specific costs for both ULLS users and Telstra. A reconciliation policy can secure these gains for all parties very simply and requires virtually no new information to implement. The implementation of a reconciliation policy also can help to secure more accurate forecasts of ULLS demand, and thereby can reduce the amount of reconciliation of payments and costs that ultimately is needed.

47.    By limiting excessive or incomplete recovery of relevant ULLS-specific costs, reconciliation promotes "economically efficient investment in the [telecommunications] infrastructure" and thereby serves "the long-term interests of end-users" of telecommunications services in Australia.[27] Reconciliation also is sensitive to "the interests of persons who have rights to use the declared service" (ULLS users in particular) and to Telstra's "legitimate business interests" alike.[28] Therefore, the implementation of a reconciliation policy is entirely consistent with the ACCC's mandates.

DAVID E. M. SAPPINGTON
July 28, 2006

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[26]    *Ibid*, ¶ 5.51.

[27]    Section 152AB of the Act.

[28]    Section 152AH of the Act.