

**Before the  
AUSTRALIAN COMPETITION AND CONSUMER COMMISSION**

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In the Matter of )  
 )  
Assessment of Telstra's Unconditioned Local )  
Loop Service Monthly Charge Undertakings )  
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**EXPERT REPORT OF DAVID E. M. SAPPINGTON ON  
THE MERITS OF UNIFORM ULLS PRICES**

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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.

#### **INTRODUCTION AND OVERVIEW**

10. I have been asked by Telstra Corporation Ltd. (“**Telstra**”) to provide my expert opinion on the merits of implementing uniform prices for unconditioned local loop service (“**ULLS**”) throughout Australia. By uniform prices throughout Australia, I mean prices that are the same in the various regions of Australia and that reflect the average cost of providing ULLS throughout Australia.

11. My primary conclusion is that uniform ULLS prices are consistent with and help to mitigate the deleterious effects of the uniform retail price mandate, which requires Telstra to charge the same price for unbundled basic access service throughout Australia. Uniform ULLS prices help to limit the cream-skimming that undermines the uniform retail price mandate. Uniform ULLS prices also can enhance competitive activity in rural regions of Australia and help to limit the operation of inefficient suppliers in urban regions. Therefore, although uniform ULLS prices (like all other ULLS pricing structures) are not ideal in every respect, they constitute a reasonable policy in Australia as long Telstra continues to face the uniform retail price mandate.

12. I develop and present my conclusions as follows. After briefly reviewing relevant industry details, I discuss the outcomes that intense, unfettered competition would produce in the telecommunications industry. Then I explain how the obligation that has been imposed unilaterally on Telstra to charge a uniform price for unbundled basic access service produces outcomes other than the competitive outcomes. I note in particular that the uniform retail price mandate encourages competitive activity in urban regions and discourages competitive activity in rural regions.

13. Next, I explain how uniform ULLS prices can help to counter-balance the deleterious effects of the uniform retail price mandate. I show how, by reducing ULLS prices below cost in rural regions and raising them above cost in urban regions, uniform ULLS prices help to equalize the attraction of supplying telecommunications services in all regions of Australia. In doing so, uniform ULLS prices can help to restore competitors' interests in serving the rural regions of Australia, and thereby further "the objective of promoting competition" and so serve "the long-term interests of end-users."<sup>1</sup>

14. Before concluding, I explain why uniform ULLS prices are consistent both with standard economic principles and with the mandates set out in the Act. I also discuss the flaws in the arguments of proponents of geographically de-averaged ULLS prices. In addition, I note that the Organization for Economic Co-operation and Development ("OECD") explicitly advocates uniform ULLS prices in countries that require uniform prices for key retail services.

#### **PRELIMINARY OBSERVATIONS**

15. For expositional ease, the ensuing discussion will differentiate only between "rural" and "urban" regions of Australia. Telstra and the Australian Competition and Consumer Commission ("ACCC") routinely consider finer differentiation, distinguishing among central business district (band 1), metropolitan (band 2), provincial (band 3), and rural (band 4) regions. This finer differentiation better describes the relevant variation in Australia. However, detailed consideration of this finer differentiation would complicate the ensuing discussion without offering substantial new insight. As will become apparent, the basic conclusions that arise when a distinction between the rural and urban regions of Australia is drawn remain valid when finer differentiation among geographic regions is admitted.

16. Before proceeding, I note that my analysis reflects the following three observations, which I understand to be true. First, Telstra is required to charge the same price for unbundled basic access service to residential customers throughout Australia.<sup>2</sup> Second, the price that Telstra charges for unbundled basic access service to residential customers can exceed Telstra's unit production cost in urban regions but often is below Telstra's unit production cost in rural regions. Third, Telstra's efficient unit cost of producing ULLS generally is higher in rural regions of Australia than in urban regions.

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<sup>1</sup> Section 152AB of the *Trade Practices Act 1974* ("the Act").

<sup>2</sup> For expositional simplicity, the ensuing discussion also will abstract from the distinction between residential and business customers. Again, the conclusions drawn in the simplified discussion are valid more generally.

**I. THE MANDATE TO CHARGE A UNIFORM PRICE FOR UNBUNDLED BASIC ACCESS SERVICE CREATES DISTORTIONS**

**A. UNFETTERED COMPETITION WOULD DRIVE PRICES TO COSTS IN ALL GEOGRAPHIC REGIONS**

17. Regulation typically seeks to replicate the discipline of competitive markets.<sup>3</sup> Therefore, in assessing the most appropriate regulatory policy, it is useful to consider the outcomes that would arise under intense, unfettered industry competition. A defining feature of such competition is that it drives prices to the level of costs. If one firm charges a price for a product that exceeds the unit cost of producing the product, another firm with comparable costs can profitably charge a lower price for the product. Customers will purchase a homogeneous product from the firm that charges the lowest price for the product. Consequently, intense competition will force firms to set prices that reflect their unit production costs, and the firms with the lowest unit production costs will be able to operate profitably in the market.

18. In Australia, as in most countries, the costs of supplying basic telecommunications access services differ in different geographic regions within the country. Unit network production costs generally are higher in rural regions of Australia than in urban regions, in part because of lower population densities in rural regions. Because unfettered competition drives prices to the level of costs, unfettered competition would produce higher prices for retail basic access services in rural regions of Australia than in urban regions. Therefore, if regulation were to replicate competitive outcomes, regulation would set higher prices for retail basic access services in rural regions of Australia than in urban regions.

**B. THE UNIFORM RETAIL PRICE MANDATE INHIBITS COMPETITION IN RURAL REGIONS OF AUSTRALIA**

19. In contrast, Telstra is required to set the same price for unbundled basic access service throughout Australia.<sup>4</sup> This uniform retail price mandate has produced a situation in which the price that Telstra charges for unbundled basic access service can exceed Telstra's unit cost of production in urban regions of Australia (where costs are relatively low) and often is below Telstra's unit cost of production in rural regions of Australia (where costs are relatively high). Consequently, although Telstra may secure revenue in excess of cost when it sells unbundled basic access service to urban

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<sup>3</sup> As Alfred Kahn states, "the single most widely accepted rule for governance of the regulated industries is regulate them in such a way as to produce the same results as would be produced by effective competition, if it were feasible." (Alfred Kahn, *The Economics of Regulation: Principles and Institutions, Volume I*. New York: John Wiley & Sons, 1970, p. 17.)

<sup>4</sup> "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." *Telstra Carrier Charges – Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2005 (Amendment No. 1 of 2006)*, § 19A(1).

customers, it often suffers a financial loss (i.e., incurs costs that exceed revenues) when it sells the service to rural customers.

20. Although a uniform retail price mandate can promote the social goal of securing relatively low prices for key telecommunications services in rural regions of Australia, the price structure the mandate imposes encourages competitors to serve customers in urban regions of Australia and discourages competitive activity in rural regions.<sup>5</sup> Even a competitor with a cost structure similar to Telstra's can profitably serve customers in urban regions by charging a lower price than Telstra charges. The competitor can do so profitably when Telstra's price is set at a supra-competitive (i.e., above cost) level in urban regions in order to help finance the below-cost pricing that is implemented in rural regions to comply with the mandate to set a uniform retail price for unbundled basic access service throughout Australia. In contrast, equally efficient competitors cannot profitably undercut Telstra's prices in rural regions when Telstra's price is below the unit cost of producing the service in those regions. Even a competitor with lower costs than Telstra's may be unable to serve rural customers profitably when Telstra complies with the mandate that it alone faces to set a uniform price for unbundled basic access service throughout Australia.<sup>6</sup>

C. THE PROBLEMS CAUSED BY THE UNIFORM RETAIL PRICE MANDATE ARE READILY ILLUSTRATED

21. To illustrate these general conclusions more concretely, consider the following simple example. Suppose there are 50 consumers in the single urban region of country A and 50 customers in the single rural region in country A. Further suppose that the incumbent supplier of the single basic telecommunications service offered for sale to retail customers in country A incurs a fixed

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<sup>5</sup> The same qualitative conclusion holds even if relevant revenues exceed costs in rural regions. As long as Telstra's prices are further above costs in urban regions than in rural regions, competitors generally will find it more profitable to operate in urban regions than in rural regions of Australia.

<sup>6</sup> In theory, Telstra could lower the price it charges for unbundled basic access service in urban regions to match the price charged by competitors. Under the uniform retail price mandate, though, this price reduction would require an identical price reduction in rural regions. Such a nationwide reduction in the price of unbundled basic access would reduce Telstra's earnings unduly.

Conceivably, Telstra might reduce the prices it charges for bundles of telecommunications services in urban regions only, leaving the price of unbundled basic access unchanged throughout Australia. Telstra might then consider raising the prices of bundled services in rural regions to offset the revenue reduction resulting from the lower prices of bundled services in urban regions. However, rural customers could avoid the high prices for Telstra's bundled services by purchasing basic access from Telstra (at the regulated, low, uniform price) and securing any additional desired services from competitors.

cost of \$500.<sup>7</sup> The incumbent supplier (“T”) incurs a \$10 unit variable cost in serving urban customers and a \$30 unit variable cost in serving rural customers.<sup>8</sup>

22. If T is the sole potential and actual supplier of the basic telecommunications service in country A, T will secure zero (extra-normal) profit if it charges \$25 for its service to all customers in country A.<sup>9</sup> This price generates revenue of \$2,500 (= \$25 x 100 customers). T’s cost of serving all 100 customers also is \$2,500, which is the sum of T’s fixed cost (\$500), its variable cost in the urban region (\$500 = \$10 per customer x 50 customers), and its variable cost in the rural region (\$1,500 = \$30 per customer x 50 customers.)

23. Notice that with a uniform price of \$25, the revenue T secures from serving urban customers (\$1,250 = \$25 x 50) exceeds the variable cost (\$500 = \$10 x 50) of serving these customers by \$750. In contrast, the variable cost T incurs in serving rural customers (\$1,500 = \$30 x 50) exceeds the revenue T receives from these customers (\$1,250 = \$25 x 50) by \$250. The excess of revenue over variable cost in the urban region makes this region an attractive target for competitors. The excess of variable cost over revenue in the rural region renders this region unattractive to competitors.

24. More specifically, consider the decision of a competitor with the same cost structure as T. This competitor can earn substantial profit by undercutting T’s price in the urban region and declining to offer service in the rural region. For example, if the competitor charges \$24 in the urban region while T charges \$25 for the (identical) service, all customers will purchase the service from the competitor. The competitor’s revenue will be \$1,200 (= \$24 x 50 urban customers). The competitor’s total production cost will be \$1,000, which is the sum of its fixed cost (\$500) and its variable cost (\$500 = \$10 per customer x 50 customers). Thus, a competitor with the same cost structure as Telstra’s will be able to profitably serve all urban customers at a price below the lowest uniform nation-wide price that is compensatory (i.e., generates non-negative profit) for T.

25. Notice that the competitor would be able to serve all urban customers profitably even if it had higher costs than T. For example, suppose the competitor’s unit variable cost of serving urban customers were \$12, rather than \$10. (Continue to assume the competitor’s fixed cost of production is \$500.) In this setting, the competitor could again attract all urban customers away from T by

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<sup>7</sup> A fixed cost is a production cost that does not vary as the number of units of the service supplied varies. This fixed cost can be viewed as a general administrative overhead cost that the firm incurs in serving its customers, for example.

<sup>8</sup> Each of these variable costs is best viewed as the long run average incremental cost of serving the population in question.

<sup>9</sup> Extra-normal profit is profit in excess of the amount required to ensure ongoing operation by the producer.

charging a price of \$24. The (less efficient) competitor would earn a profit of \$100 by doing so. This profit is the difference between the competitor's revenue \$1,200 (= \$24 x 50 urban customers) and its total production cost, \$1,100. The competitor's total production cost is the sum of its fixed cost (\$500) and its variable cost (\$600 = \$12 per customer x 50 customers).

26. Notice also that a competitor might be unable to profitably serve customers in the rural region even if it had lower costs than T. To illustrate this point, suppose a competitor had the same fixed cost (\$500) and the same unit variable cost of serving urban customers (\$10) as T, but had a \$28 unit variable cost of serving customers in the rural region. Even if all rural customers chose to purchase the competitor's service rather than T's service when the two firms charged the same \$25 price, the competitor could not profitably serve only the rural customers in country A. The competitor's revenue from charging the highest price (\$25) that would allow it to attract rural customers is \$1,250 (= \$25 x 50 customers). The competitor's total production cost would be \$1,900, the sum of its fixed cost (\$500) and variable cost (\$1,400 = \$28 per customer x 50 customers). Thus, even this more efficient competitor would lose \$650 (= \$1,900 - \$1,250) if it tried to serve only rural customers.<sup>10</sup>

27. This example illustrates the more general principle that a mandate to charge a uniform retail price for unbundled basic access service throughout Australia will encourage competitive activity in urban regions and discourage competitive activity in rural regions. The example also reveals why the uniform retail price mandate can allow inefficient competitors to operate profitably in urban regions of Australia while precluding the profitable operation of efficient competitors in rural regions of Australia.

#### D. THE UNIFORM RETAIL PRICE MANDATE ENCOURAGES CREAM-SKIMMING, WHICH UNDERMINES THE MANDATE

28. The example also illustrates the more general principle that uniform retail prices for telecommunications services throughout Australia may not be sustainable. As competitors rationally choose to serve lucrative urban regions, prices will be driven down in these regions. If Telstra wishes to continue to serve urban customers, it will be compelled to lower the prices it charges for telecommunications services in urban regions. A reduction in the price of unbundled

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<sup>10</sup> Notice also that this competitor with lower costs of serving rural customers than T would prefer to serve only urban customers than to serve all customers in country A. Even if it were able to serve all 100 customers by matching T's price of \$25, the competitor would earn only \$100 in profit. This profit is the difference between revenue (\$2,500 = \$25 x 100) and cost (\$2,400). This cost is the sum of fixed costs (\$500), variable costs in the urban region (\$500 = \$10 x 50), and variable costs in the rural region (\$1400 = \$28 x 50). The competitor would earn greater profit (as much as \$250) if it served only urban customers. This \$250 profit is the difference between the maximum revenue the competitor could secure from urban customers (\$1,250 = \$25 x 50) and the cost (\$1,000) of serving these customers. This cost is the sum of fixed costs (\$500) and variable costs (\$500 = \$10 x 50).



basic access service in urban regions would reduce Telstra's earnings unduly, as it would require an identical reduction in the price of unbundled basic access service in rural regions of Australia (given the prevailing uniform retail price mandate). A selective reduction in the prices of bundled telecommunications services in urban regions could help Telstra to retain urban customers. However, these price reductions would limit Telstra's ability to secure a reasonable return on its investments unless it could raise the prices it charges for bundled telecommunications services in rural regions of Australia. Rural customers can thwart such price increases by purchasing unbundled basic access service from Telstra at the low, regulated, uniform price and, as desired, purchasing additional services from competitors. Thus, in the face of competition, the uniform retail price mandate can limit Telstra's ability to attract the capital it needs to continue to invest in and enhance its network infrastructure.

29. The general principle that uniform prices for telecommunications services throughout Australia may not be sustainable can be illustrated by returning to the example of country A. Suppose firm T and a competitor have the same cost structure (a fixed cost of \$500 and unit variable costs of serving urban and rural regions of \$10 and \$30, respectively). T will earn zero profit in this setting if it serves all 100 customers at a uniform price of \$25. However, the competitor can profitably attract all urban customers by charging a price below \$25. If T were to reduce its price to all customers below \$25, it would earn negative profit. Consequently, the uniform retail price mandate will compel T to stop serving customers in the urban region, assuming it is permitted to do so.<sup>11</sup> If it were to serve only rural customers, T would need to charge a price of \$40 in order to cover its costs. The \$40 price would generate \$2,000 (= \$40 x 50 rural customers) in revenue, which is precisely T's cost of serving rural customers. This cost is the sum of T's fixed cost (\$500) and variable cost (\$1,500 = \$30 per customer x 50 rural customers).

30. When a uniform retail price requirement is imposed on T while the operation of an equally efficient competitor is not regulated in this example, one of two outcomes will arise. Either the price that T is permitted to charge to its (rural) customers in country A will have to be increased to reflect T's higher unit cost of production, or T will be unable to operate profitably and so will be driven from the industry. In either case, competition among multiple suppliers will ensure that urban customers enjoy lower prices than rural customers, despite the mandate imposed

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<sup>11</sup> Many incumbent providers of basic telecommunications services (like Telstra, for example) face carrier of last resort ("COLR") obligations that require the incumbent supplier to serve all customers, including those that are unprofitable to serve. In (realistic) settings where the cost of serving individual customers varies within an "urban" region, competitors may choose to serve only those urban customers that are the least costly to serve and leave the incumbent supplier to serve the more costly urban customers. In such settings, COLR obligations can reduce an incumbent supplier's profit below the level it could secure by serving only rural customers.

(unilaterally) on T. Thus, uniform retail prices and ubiquitous, economic service by T are fundamentally incompatible in this setting. This conclusion holds even if competitors have higher costs than T. As illustrated above, if such competitors are permitted to serve only the regions that they find profitable to serve and decline to operate in unprofitable regions (a practice commonly referred to as “cream-skimming”), they can profitably undercut T’s price in the urban region. Doing so will relegate T to serving only rural customers. If T is to be able to serve its (rural) customers economically, the price that T is permitted to charge will have to be raised well above the (\$25) price that allowed T to cover its costs when it served all customers in country A.

31. The conclusions drawn in this simple example are relevant in Australia. Competitors with costs similar to Telstra’s will be able to engage in cream-skimming. When cream-skimming reduces the number of urban customers Telstra serves and/or requires Telstra to sell bundled services to urban customers at low rates, Telstra’s ability to finance low prices in rural regions will be jeopardized.<sup>12</sup> Consequently, if Telstra is to 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 will have to be increased (absent other policies to compensate Telstra for the losses it incurs in serving rural customers). 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.<sup>13</sup> Such failure also would not serve the best “interests of persons who have the right to use” the ULLS<sup>14</sup> because Telstra must be able to attract the resources required to maintain and improve its network in order to continue to make high-quality ULLS available to competitors.

## **II. GEOGRAPHICALLY DE-AVERAGED ULLS PRICES FACILITATE CREAM-SKIMMING WHILE UNIFORM ULLS PRICES LIMIT CREAM-SKIMMING**

### **A. GEOGRAPHICALLY DE-AVERAGED ULLS PRICES FACILITATE CREAM-SKIMMING**

32. ULLS prices that reflect Telstra’s region-specific (efficient) costs of supplying unconditioned local loops facilitate cream-skimming. Telstra’s unit costs of producing ULLS are lower in urban

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<sup>12</sup> In theory, the Universal Service Regime could be employed to finance low prices for telecommunications services in rural regions of Australia. However, my understanding is that, in practice, the Regime fails to compensate Telstra fully for the losses it incurs in serving unprofitable rural customers. This understanding reflects, for example, the observations in 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).

<sup>13</sup> Section 152 AH of the Act.

<sup>14</sup> *ibid.*

regions than in rural regions of Australia. Consequently, if ULLS prices (unlike Telstra's retail prices) were geographically de-averaged to fully reflect Telstra's efficient region-specific costs, competitors that employ ULLS would enjoy lower costs in urban regions than in rural regions. Such a cost structure would make competitors particularly capable of and especially interested in serving urban regions while rendering the competitors less capable of and less interested in serving rural regions of Australia. Thus, geographically de-averaged ULLS prices would encourage the cream-skimming that can both undermine the goal of securing a uniform price for basic access service throughout Australia and increase Telstra's unit production cost and thereby compel Telstra to raise prices to rural customers.<sup>15</sup>

#### B. UNIFORM ULLS PRICES LIMIT CREAM-SKIMMING

33. Uniform ULLS prices limit incentives for cream-skimming. Uniform ULLS prices are prices for ULLS service that are the same throughout Australia. Uniform ULLS prices that reflect Telstra's efficient (geographically averaged) unit cost of supplying ULLS in Australia endow competitors with a low-cost means of operation while limiting their ability and incentive to undertake the cream-skimming that subverts the goal of securing a low, uniform price for unbundled basic access service throughout Australia.

34. Uniform ULLS prices limit cream-skimming and can promote competitive activity in the rural regions of Australia by increasing the relative profitability of serving rural customers. A uniform ULLS price coupled with a uniform retail price for Telstra's basic access service provides competitors that employ ULLS with commensurate opportunities for profitable operation in rural and urban regions of Australia. By providing such commensurate opportunities, uniform ULLS prices help to offset the differential attraction of serving urban regions that the uniform retail price mandate creates.

#### C. THE BENEFITS OF UNIFORM ULLS PRICES ARE READILY ILLUSTRATED

35. To illustrate how uniform ULLS prices can limit cream-skimming and enhance competitors' incentives to serve rural customers quite generally, return to the example introduced above. Suppose that competitors find it prohibitively expensive to install their own loops, and so rely upon

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<sup>15</sup> In explaining its support for geographically de-averaged ULLS prices, the ACCC states that "Telstra should not be compensated for the effects of competition or regulatory processes which promote more competitive outcomes" (ACCC, *Assessment of Telstra's ULLS Monthly Charge Undertakings*, Confidential Draft Decision, June 2006 ["ACCC, *Draft Decision*"], Appendix C.4.2, p. 68). It is not clear that increased cream-skimming is properly viewed as a "more competitive outcome." Unfettered competition enables more efficient competitors to drive less efficient rivals from the market. In contrast, cream-skimming can promote the operation of inefficient competitors in urban regions and preclude the operation of efficient competitors in rural regions.

ULLS to serve retail customers in country A. When they operate using ULLS, competitors incur a \$500 fixed cost, ULLS prices, and an additional \$5 unit variable cost.<sup>16</sup> T's efficient (and actual) physical unit cost of supplying ULLS service is \$5 in the urban region and \$25 in the rural region of country A. T's retail operations continue to entail a fixed cost of \$500 and a unit variable cost of \$10 in the urban region and \$30 in the rural region of country A. (T's unit variable production costs are summarized in Table 1.) A uniform retail price of \$25 secures zero profit for T if it can serve all retail customers at that price.

	Urban Region	Rural Region
ULLS	\$5	\$25
Retail Service	\$10	\$30

**Table 1. T's Unit Variable Production Costs.**

36. Suppose ULLS prices were de-averaged to reflect T's region-specific unit cost of producing ULLS. Then the ULLS price would be \$5 in the urban region and \$25 in the rural region. These de-averaged ULLS prices, coupled with a competitor's additional unit variable cost of \$5, allow a competitor to operate with a \$500 fixed cost, a unit variable cost of \$10 in the urban region, and a unit variable cost of \$30 in the rural region of country A. Thus, the competitor secures the same cost structure as T. As explained above, competitors with the same cost structure as T will engage in cream-skimming to take advantage of the supra-competitive price that T charges in the urban region to finance the below-cost price T charges in the rural region. Furthermore, competitors will not serve customers in the rural region where the uniform retail price is below the unit variable cost of providing service.

37. Now consider the changes that arise when uniform ULLS prices are adopted. The uniform ULLS price that reflects T's unit cost of supplying ULLS is \$15 (the average of \$5 and \$25). This \$15 ULLS charge, coupled with the additional \$5 unit variable cost competitors incur, allow a competitor to operate with a \$500 fixed cost and a \$20 unit variable cost in both the urban and the rural regions of country A. Given T's uniform retail price of \$25, competitors now perceive the rural and urban regions to be equally profitable. Consequently, competitors will now vie with T for the right to serve all customers in country A, rather than focus their attention exclusively on urban customers. If competitors are able to operate at even slightly lower cost than T in this simple setting, they will be able to profitably serve all customers in country A. Furthermore, an efficient

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<sup>16</sup> This additional \$5 cost can be viewed as a variable cost of combining ULLS with other inputs to produce the final basic telecommunications service that is marketed to retail customers. This \$5 cost is not an essential element of the ensuing discussion.

competitor will find it more profitable to serve all customers in country A than to serve only urban customers. By reducing its retail price below \$25 throughout country A, the especially efficient competitor will be able to serve all customers, and thereby spread its fixed cost of production over a large customer base, and so reduce its unit cost of production.

38. Notice that by rendering more commensurate the financial gains competitors anticipate from serving rural and urban customers, a uniform ULLS price helps to ensure similar retail prices in rural and urban regions, even when competitors serve the customers that T formerly served. In contrast, rural customers were forced to pay higher retail prices than their urban counterparts when geographically de-averaged ULLS prices induced competitors to focus their attention on urban customers, and ultimately led to an increase in the price T was permitted to charge to its (rural) customers, in accordance with T's unavoidably higher unit cost of production.

39. While this example is simple and stylized, it illustrates the important general principle that uniform ULLS prices will produce three important benefits in Australia. First, they will limit cream-skimming. Second, they can enhance competitive activity in rural regions. Third, uniform ULLS prices can help to support a low, uniform price for unbundled basic access service throughout Australia.

### III. UNIFORM ULLS PRICES ARE CONSISTENT WITH ECONOMIC PRINCIPLES AND INDUSTRY PRACTICE

#### A. UNIFORM ULLS PRICES ARE CONSISTENT WITH ECONOMIC PRINCIPLES

40. These advantages of uniform ULLS prices arise because the uniform prices are consistent with basic economic principles. As noted above, regulation often seeks to replicate the discipline of competitive markets, and (absent regulatory distortions) prices typically are driven to the level of costs in competitive markets. Therefore, one might suspect that the ideal regulatory policy would be to set ULLS prices at levels that reflect the (geographically de-averaged) costs of providing ULLS. Although this logic is intuitively appealing, it is not correct because it ignores the fundamental Principle of the Second Best.

41. In essence, the Principle of the Second Best states that if one component of a fully ideal ("first-best") policy is precluded, then it is no longer necessarily best to implement the other components of the first-best policy.<sup>17</sup> In other words, once a single departure from the first-best policy arises, it can be best to intentionally implement additional departures to help offset the distortions created by the initial departure.

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<sup>17</sup> See, for example: (i) R. G. Lipsey and Kelvin Lancaster, "The General Theory of Second Best," *Review of Economic Studies*, 24(1), 1956-1957, pp. 11-32; and (ii) Joseph Stiglitz, *Economics of the Public Sector* (Third Edition). New York: W.W. Norton & Company, 2000, p. 551.

42. In the present context, the Principle of the Second Best implies that once a decision has been made to preclude Telstra’s retail prices for basic access service from reflecting the geographically de-averaged costs of producing the service, it can be optimal to preclude the corresponding de-averaging of ULLS prices. The first-best policy – the one that faithfully replicates all of the outcomes that would arise if all relevant markets were competitive – would set the price for Telstra’s basic access service and the price for Telstra’s wholesale service (i.e., ULLS) at levels that reflect Telstra’s efficient, geographically de-averaged costs of providing these services. However, once Telstra’s prices for basic access service are precluded from reflecting the geographically de-averaged costs of producing this service, it can be best to set wholesale prices that similarly depart from the geographically de-averaged costs of producing the wholesale services.

43. The advantages of setting uniform wholesale prices are apparent. As explained above, Telstra’s mandate to set a uniform price for unbundled basic access service throughout Australia encourages cream-skimming, discourages competitive activity in rural regions, and ultimately either will limit Telstra’s ability to attract the capital it requires to continue to deliver high-quality services to its customers or will require an increase in the price that Telstra is permitted to charge for unbundled basic access service in the rural regions of Australia. For the reasons identified above, uniform ULLS prices can help to offset these effects of the uniform retail price mandate. Uniform ULLS prices can: (i) limit cream-skimming; (ii) enhance competitive activity in rural regions; and (iii) help to support a low, uniform price for basic access service throughout Australia. In doing so, uniform ULLS prices: (1) are consistent with “the objective of promoting competition”; (2) further “the objective of encouraging the economically efficient use of, and the economically efficient investment in the [telecommunications] infrastructure”; and (3) promote “the long-term interests of end-users” of telecommunications services in Australia.<sup>18</sup>

44. Uniform ULLS prices accomplish these outcomes by raising ULLS prices above cost in urban regions and lowering ULLS prices below cost in rural regions. Uniform ULLS prices thereby help to: (i) offset the artificial attraction of serving urban customers created by the uniform retail price mandate; and (ii) increase the attraction of serving rural customers by lowering the costs of serving rural customers for competitors that employ ULLS. Uniform ULLS prices thereby make it more profitable for competitors to serve all of Australia rather than serving only selected geographic (i.e., urban) regions of the country.<sup>19</sup>

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<sup>18</sup> Sections 152AB and 152AH of the Act.

<sup>19</sup> As standard economic analysis reveals, an alternative policy to limit cream-skimming and to support uniform retail tariffs is to tax the services that competitors sell in urban regions. (See, for example, Mark Armstrong, “The Theory of Access Pricing and Interconnection,” in Martin Cave, Sumit Majumdar, and

## B. UNIFORM ULLS PRICES REFLECT THE FULL COSTS OF COMPETITIVE ENTRY

45. Uniform ULLS prices better reflect the full cost that Telstra incurs when it supplies ULLS to competitors than do geographically de-averaged ULLS prices. Telstra's full cost of supplying ULLS includes both its physical production cost and the increased financial deficit it faces when competitors employ ULLS to attract profitable customers away from Telstra. When Telstra loses profitable customers to competitors, Telstra forfeits the financial contribution these customers formerly made to help cover Telstra's fixed costs of production. The reduction in contribution that arises when Telstra supplies ULLS to competitors is more pronounced the greater is the profit Telstra formerly secured from the customers that competitors now serve.<sup>20</sup>

46. Recall that under the mandate to set a uniform price for basic access service, urban customers are more profitable for Telstra (and competitors) to serve than rural customers. Therefore, Telstra incurs a larger reduction in contribution to its fixed production costs when competitors use ULLS to attract customers in urban regions than when they employ ULLS to attract customers in rural regions of Australia. In this sense, holding constant the physical cost of producing ULLS, the full cost of supplying ULLS is higher in urban regions than in rural regions.

47. Of course, the physical cost of producing ULLS is lower in urban regions than in rural regions. Therefore, a policy that took no account of the relatively large reduction in contribution that arises when ULLS is supplied in urban regions of Australia would set a lower ULLS price in urban regions than in rural regions. In contrast, uniform ULLS prices can be viewed as accounting for the more pronounced reduction in contribution associated with supplying ULLS in urban regions than in rural regions. In this sense, uniform ULLS prices better reflect the full costs of supplying ULLS than geographically de-averaged ULLS prices. Basic economic principles and standard economic analysis document the merits of setting prices that reflect the full costs (including the costs associated with reduced contribution to cover fixed costs of production) of providing wholesale services to competitors.<sup>21</sup>

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Ingo Vogelsang, eds., *Handbook of Telecommunications Economics: Volume I*. Amsterdam: North-Holland, 2002, pp. 295-384.)

<sup>20</sup> It is important to note that the issue here is not the recovery of foregone monopoly profit that is unsustainable in the presence of competitive pressures. The issue is the recovery of a cost that an incumbent supplier unavoidably incurs when it provides access to competitors that are free to engage in cream-skimming while the incumbent supplier faces COLR obligations and a uniform retail price mandate.

<sup>21</sup> See, for example: (i) Mark Armstrong, Chris Doyle, and John Vickers, "The Access Pricing Problem: A Synthesis," *Journal of Industrial Economics*, 44(2), June 1996, pp. 131-150; and (ii) Armstrong, 2002, *op cit*. The ACCC notes that such "competition effects should not be taken into account" when assessing whether ULLS prices reflect the direct costs of providing access (ACCC, *Draft Decision*, Appendix C.4.4, p. 69). This observation does not imply that relevant competition effects should be ignored more

### C. THE OECD ADVOCATES UNIFORM ULLS PRICES

48. In its comprehensive assessment of access pricing policies in the telecommunications industry, the OECD advocates uniform ULLS prices in settings where uniform prices are mandated for key retail services.<sup>22</sup> The OECD states:

“... 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.”<sup>23</sup>

49. The OECD also observes that most countries employ uniform ULLS prices, and notes that Australia is an exception in this regard.

“Consistent with geographically-averaged end-user prices, the regulated tariffs for unbundled local loops are usually geographically averaged. ... In fact ULL access prices are usually geographically averaged even in those countries which claim that they are using a “cost-based” or “cost-oriented” approach to the regulation of ULL. ... Australia is one of the few countries with geographically-averaged tariffs for end-users, but geographically de-averaged prices for ULL.”<sup>24</sup>

50. The OECD also emphasizes that geographically de-averaged ULLS prices will induce competitors to focus their attention on urban regions, to the detriment of end-users in rural regions of Australia:

“[A]s long as Telstra’s final prices remain geographically averaged (and this may be forced to change), de-averaging ULL prices ... runs the risk that local loop unbundling will be restricted to low-cost areas, such as CBD [central business district] and urban areas, to the exclusion of customers in rural and remote areas.”<sup>25</sup>

51. The OECD’s observations make it clear that uniform ULLS prices are consistent with generally recommended policy and with regulatory policy throughout the world, in addition to being consistent with basic economic principles and with the ACCC’s mandates.

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generally (e.g., when assessing whether proposed ULLS prices promote the long-term interests of end-users).

<sup>22</sup> Organization for Economic Co-operation and Development. *Access Pricing in Telecommunications*. Paris: OECD, 2004 [“**OECD Report**”].

<sup>23</sup> *ibid*, p. 134.

<sup>24</sup> *ibid*, p. 135.

<sup>25</sup> *ibid*.



#### D. THE UNIFORM RETAIL PRICE MANDATE PRECLUDES FIRST-BEST POLICIES

52. As the term “second best” in the Principle of the Second Best implies, policies that help to offset the distortions created by the uniform retail price mandate cannot be expected to perform perfectly in every respect. Although it limits incentives for cream-skimming and encourages competitive activity and lower retail prices in the rural regions of Australia, a uniform ULLS price will not always ensure the cost-minimizing industry structure. In principle, a uniform ULLS price could allow inefficient competitors to operate profitably in rural regions while limiting the profitable operation of efficient ULLS-based competitors in urban regions of Australia.

53. These possibilities arise from standard considerations. A uniform ULLS price will be below Telstra’s efficient physical cost of supplying ULLS in rural regions and exceed Telstra’s corresponding cost in urban regions. In this sense, a uniform ULLS price subsidizes competitive activity that employs ULLS in rural regions and taxes competitive activity that employs ULLS in urban regions. Although such subsidies and taxes can work nicely to reverse the incentives for cream-skimming and the incentives for limited competitive activity in rural regions created by the uniform retail price mandate, the subsidies can, in principle, allow a competitor that is less efficient than Telstra to employ ULLS to operate profitably in rural regions while limiting the success of an efficient ULLS-based competitor in urban regions.

54. Of course, because the uniform retail price mandate compels Telstra to set below-cost prices for unbundled basic access service in many rural regions of Australia, profitable operation in these regions may be difficult for inefficient suppliers. Consequently, the possibility that inefficient operators will prosper in rural regions may be of limited practical relevance. Furthermore, efficient producers may be able to operate profitably in urban regions using alternatives to ULLS, including full facilities-based operation.

55. By effectively subsidizing ULLS in rural regions, a uniform ULLS price also could, in principle, encourage competitors to substitute ULLS for less costly means of production (e.g., full facilities-based operation) in rural regions. Conversely, the implicit tax that a uniform ULLS price places on ULLS in urban regions could encourage competitors to favor more costly means of production in these regions.<sup>26</sup> Of course, if full facilities-based operation is prohibitively expensive for competitors in rural regions, then the subsidization of ULLS will not alter a competitor’s choice

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<sup>26</sup> As the OECD notes, “Geographic averaging of ULL charges has the disadvantage that it may induce inefficient network duplication in low-cost areas. Entrants will have strong incentives to duplicate existing networks in regions where the incumbent’s charges are above cost and little incentive to build duplicative networks (even when it is efficient to do so) in regions where the incumbent’s charges are below cost” (OECD Report, p. 134). Of course, distinct facilities can facilitate product differentiation that enables industry suppliers to better serve the diverse needs and desires of consumers.

between ULLS and full facilities-based operation.<sup>27</sup> Also, if the local loop exhibits substantial scale economies in urban regions, competitors may find ULLS-based operation to be the least-cost means of operation even when ULLS prices are set above cost in order to help support the uniform retail price mandate.

56. Just as uniform ULLS prices can raise industry costs, so can geographically de-averaged ULLS prices, even as they facilitate cream-skimming and undermine the uniform retail price mandate. De-averaged ULLS prices coupled with uniform prices for unbundled basic access service can allow inefficient competitors to operate profitably in urban regions while precluding in rural regions the profitable operation even of competitors that are more efficient than Telstra.<sup>28</sup> Thus, neither uniform nor geographically de-averaged ULLS prices ensure that industry output is delivered by the least-cost industry supplier.

57. A key qualitative difference between geographically de-averaged and uniform ULLS prices is that the former promote competitive activity (even to the point of facilitating the operation of inefficient competitors) in urban regions while the latter promote corresponding competitive activity in rural regions. The other central difference between the two policies – and likely the difference of greatest practical importance as competitive pressures build in Australia’s telecommunications industry – is that geographically de-averaged ULLS prices facilitate the cream-skimming that undermines the uniform retail price mandate while uniform ULLS prices limit cream-skimming.

#### E. FIRST-BEST POLICIES MERIT CONSIDERATION

58. The distortions that can arise under both geographically de-averaged and uniform ULLS prices could be avoided if Telstra were permitted to set prices for unbundled basic access service that fully reflect efficient production costs. Such prices would eliminate the need for uniform ULLS prices to help offset the incentives for cream-skimming and for limited competitive activity in rural regions that the uniform retail price mandate creates. If the uniform retail price mandate were no longer imposed, concerns about the affordability of basic access services in rural regions of Australia could be addressed through more direct and more targeted programs. For example,

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<sup>27</sup> Furthermore, the prices charged for Telstra’s services that competitors resell to retail customers can be synchronized with uniform ULLS charges to ensure that competitors choose to: (i) resell Telstra’s services when such resale is more efficient than operating via ULLS; and (ii) operate via ULLS when doing so is more efficient than reselling Telstra’s services.

<sup>28</sup> Inefficient competitors can operate profitably in urban regions because Telstra is constrained to set a supra-competitive price in urban regions in order to help finance a below-cost price in rural regions. The below-cost price in rural regions explains why even a competitor with lower costs than Telstra may not be able to operate profitably in rural regions when Telstra is required to set a uniform price for unbundled basic access service throughout Australia.

general tax revenues could be employed to provide the financial assistance that low-income rural residents might need to afford basic telecommunications services that are priced to reflect efficient production costs.<sup>29</sup> More direct, more targeted programs of this type can address relevant affordability concerns while avoiding the many complications and distortions introduced by the mandate to charge a uniform price for unbundled basic access service throughout Australia. Consequently, these more targeted programs promote “the long-term interests of end-users” of telecommunications services while “encouraging the economically efficient use of, and the economically efficient investment in the [telecommunications] infrastructure” in Australia.<sup>30</sup>

#### IV. ARGUMENTS FOR DE-AVERAGED ULLS PRICES ARE FLAWED

##### A. THE MARSDEN JACOBS ASSOCIATES’ REPORT UNDERESTIMATES TELSTRA’S COMPETITIVE DISADVANTAGES AND THE ROLE OF UNIFORM ULLS PRICES IN REFLECTING OPPORTUNITY COSTS

59. The Marsden Jacobs Associates’ report (“**MJA report**”) suggests that uniform prices would enable Telstra to “achieve a competitive advantage” that would allow it to “undercut its [urban] competitors and capture greater market share.”<sup>31</sup> A full assessment of competitive advantage in Australia’s telecommunications industry requires explicit consideration of both prevailing cost asymmetries and asymmetric pricing restrictions and COLR obligations. The uniform retail price mandate prevents Telstra from reducing the price it charges for unbundled basic access in urban regions of Australia without implementing the same price reduction in rural regions. Therefore, Telstra is not at liberty to engage in the selective price cutting in urban regions that the MJA report appears to envision. Furthermore, Telstra does not enjoy its competitors’ freedom to operate in profitable markets and decline to operate in markets where below-cost prices are mandated. Uniform ULLS prices help to limit the losses caused by these competitive disadvantages that have been imposed on Telstra.<sup>32</sup>

60. The MJA report recognizes appropriately that “there are both advantages and disadvantages ... of the different [ULLS] pricing regimes,” and that “there are aspects of the current framework [for setting geographically de-averaged ULLS prices] that are incompatible with a concept of

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<sup>29</sup> The financial assistance might take the form of vouchers that low-income, rural residents of Australia could employ to purchase basic telecommunications access services from their preferred authorized supplier.

<sup>30</sup> Sections 152AB and 152AH of the Act.

<sup>31</sup> Marsden Jacob Associates, *Averaging vs. De-averaging*, March 28, 2006, p. 14.

<sup>32</sup> AUSTAR also does not appear to take full account of the restrictions that are imposed asymmetrically on Telstra when it suggests that “fair prices for wholesale services should be cost-reflective to the extent commercially practicable” (AUSTAR, *Response to ACCC Discussion Paper “Telstra’s Undertakings for the Unconditioned Local Loop Service”*, March 2006, [“**AUSTAR submission**”], p. 4).

competitive neutrality.”<sup>33</sup> Thus, the MJA report recognizes the subtle and conflicting forces that arise when setting ULLS prices in the presence of a uniform retail price mandate.<sup>34</sup>

61. Despite this recognition, the MJA report appears to underestimate the value of uniform ULLS prices in counteracting the problems introduced by the uniform retail price mandate in Australia. The MJA report suggests that “From a purest economic view, unbundling should be de-averaged regardless of retail prices being averaged.”<sup>35</sup> This conclusion is incorrect because it appears to overlook the fact that uniform prices can help to reflect relevant opportunity costs.<sup>36</sup> A uniform ULLS price that exceeds the physical cost of supplying ULLS in urban regions can serve to reflect Telstra’s opportunity cost of supplying ULLS in urban regions, given the uniform retail price mandate in Australia. By accounting for relevant opportunity costs, uniform ULLS prices can help to limit cream-skimming by inefficient suppliers, and thereby encourage “the economically efficient use of, and the economically efficient investment in the [telecommunications] infrastructure” in Australia.<sup>37</sup> By helping to support the uniform retail price mandate and by helping to encourage competition in rural regions, uniform ULLS prices also can help to promote “the long-term interests of end-users.”<sup>38</sup>

62. The MJA report is correct in noting that the ideal policy is to move “retail prices toward cost levels.”<sup>39</sup> However, if such an ideal rebalancing of retail tariffs is not implemented, the second-best policy of implementing ULLS prices that reflect both physical production costs and opportunity costs is appropriate. As the MJA report observes correctly, “a price based on opportunity costs sends the right signal to consumers.”<sup>40</sup>

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<sup>33</sup> MJA report, pp. 7, 10.

<sup>34</sup> In this regard, the MJA report notes the reluctance of the European Commission “to provide any firm recommendations on whether averaging or de-averaging of ULL prices should be adopted” (p. 10). However, the MJA report does not mention the OECD’s strong conclusion that “[I]f the regulator wishes to preserve the geographically-averaged structure of end-user prices, it is essential to geographically average ULL prices” (OECD Report, p. 134).

<sup>35</sup> MJA report, p. 7.

<sup>36</sup> Recall the correct conclusion that “the structure of access charges should reflect the structure of end-user charges” (OECD Report, p. 134).

<sup>37</sup> Section 152AB of the Act.

<sup>38</sup> Section 152AH of the Act.

<sup>39</sup> MJA report, p. 7.

<sup>40</sup> *ibid*, p. 3.

B. THE OPTUS UU SUBMISSION IGNORES THE ADVANTAGES OF UNIFORM ULLS PRICES AND THE DISADVANTAGES OF GEOGRAPHICALLY DE-AVERAGED ULLS PRICES

63. Like the MJA report, the Optus submission on the ULLS Undertakings (“**Optus UU submission**”)<sup>41</sup> appears to underestimate the role that uniform ULLS prices can play in reflecting relevant opportunity costs. An alternative possibility is that the Optus UU submission dismisses the relevance of opportunity costs, with no substantive support for doing so.<sup>42</sup> Regardless of the relevant explanation, the failure of the Optus UU submission to recognize the role that uniform ULLS prices can play in reflecting relevant opportunity costs dilutes the value of the submission.

64. The Optus UU submission also fails to acknowledge the drawbacks to geographically de-averaged ULLS prices. For example, the submission does not discuss the fact that geographically de-averaged ULLS prices, coupled with a uniform retail price mandate, can enable inefficient competitors to thrive in urban regions while precluding the operation of efficient competitors in rural regions of Australia.<sup>43</sup> (Recall the discussion in section IIA above.) The submission also fails to discuss in any detail the fact that geographically de-averaged ULLS prices promote the continued undermining of the uniform retail price mandate.

65. In quoting the OECD’s comprehensive study of ULLS pricing, the Optus UU submission fails to report the OECD’s conclusion that “[I]f the regulator wishes to preserve the geographically-averaged structure of end-user prices, it is essential to geographically average ULL prices.”<sup>44</sup> In this respect and others, the UU Optus submission fails to provide a balanced discussion of a complex set of subtle issues.

C. [c-i-c]

66. [c-i-c]

67. [c-i-c]

68. [c-i-c]

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<sup>41</sup> *Optus Submission to Australian Competition and Consumer Commission on Telstra’s ULLS Undertakings*, Public Version, March 2006.

<sup>42</sup> The Optus UU submission asserts that “Any direct revenue loss arising as a result of increased competition in the market should be seen as a positive outcome to the extent that it likely reflects lost rents by Telstra” (p. 6).

<sup>43</sup> Instead, the Optus UU submission simply notes that “It would not be financially viable for Optus and its competitors to roll-out ULLS-based networks to the same extent as it possibly could under de-averaged pricing” (p. 5). This statement does not consider the possibility that the present roll-out of ULLS-based network may be excessive in urban regions (due to cream-skimming), so that the alleged reduced roll-out might well be consistent with “the economically efficient use of, and the economically efficient investment in the [telecommunications] infrastructure” in Australia (section 152AB of the Act). This statement also does not consider the increased roll-out of ULLS-based networks that uniform ULLS prices can promote in rural regions of Australia.

<sup>44</sup> OECD Report, p. 134.

- 69. [c-i-c]
- 70. [c-i-c]
- 71. [c-i-c]
- 72. [c-i-c]

#### **SUMMARY AND CONCLUSIONS**

73. Telstra is required to set the same retail price for unbundled basic access service throughout Australia. This requirement greatly complicates the task of setting appropriate ULLS prices. The uniform retail price mandate encourages cream-skimming and discourages competitive activity in rural regions of Australia.

74. Fully de-averaged ULLS prices would be appropriate in the absence of the uniform retail price mandate. In the presence of this mandate, though, fully de-averaged ULLS prices enhance the ability of competitors to engage in cream-skimming, facilitate the operation of inefficient operators in urban regions, and discourage the operation of even particularly efficient competitors in rural regions of Australia. In contrast, uniform ULLS prices limit incentives for cream-skimming, discourage the operation of inefficient suppliers in urban regions, and enhance incentives for competitive activity in rural regions of Australia.

75. Consequently, uniform ULLS prices better serve the long-term interests of end-users in the presence of a uniform retail price mandate than do geographically de-averaged ULLS prices. Uniform ULLS prices are not ideal in every respect. However, they are consistent with basic economic principles, with the ACCC's mandates, with generally recommended policy, and with regulatory practice throughout the world.

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