

TELSTRA CORPORATION LIMITED

Fixed Line Services FAD inquiry

Consultation on proposed change to the pricing of AGVC/VLAN and implications for the prices of other fixed services

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1. Executive Summary

Telstra welcomes the opportunity to respond to the ACCC's consultation on proposed changes to the pricing of AGVC/VLAN and implications for the prices of other fixed services. The ACCC is in the process of finalising price terms for fixed line services for the FY16-19 period, with a final decision expected in September 2015. Telstra has previously submitted its views on the ACCC's Further Draft Decision.¹ On 14 August 2015, the ACCC released a consultation paper seeking industry input on a revised pricing proposal in relation to the pricing of WDSL (**ACCC proposal**). This submission sets out Telstra's views on the ACCC proposal.

The ACCC proposal seeks to reduce the price of AGVC/VLAN capacity by 45% from current regulated rates whilst maintaining an overall uniform price change across all remaining fixed services (including WDSL port prices). The ACCC considers that the benefits of this approach are that it will allow Telstra the opportunity to fully recover the overall revenue requirement as determined by the ACCC's Fixed Line Services Model (**FLSM**) whilst being flexible enough to address concerns raised by access seekers throughout the FAD process.

Telstra has concerns regarding the ACCC proposal. In terms of process, Telstra is concerned that the ACCC is proposing substantial price deviations so late in its consultations, and has given stakeholders only a week to consider it and make submissions. Industry is expecting a final decision within 5 weeks, after a process that has run for two years. We are now at a point where the ACCC is proposing to reduce a very significant price point by 45% with limited consultation, and insufficient time to undertake thorough analysis of the effects of that change. A price change of this magnitude is clearly likely to impact on bandwidth demand, with flow-on impacts for investment requirements. However, the ACCC has not allowed sufficient time for stakeholders to properly analyse these potential impacts. Telstra considers that it would be unreasonable for the ACCC to implement such a significant change without allowing for appropriate consultation, and without proper consideration of the potential consequences.

Further, the significant reduction in the AGVC/VLAN capacity price from current rates will have the effect of moving further away from price stability, have unintended consequences for the migration to the NBN, and result in increased congestion and possible degradation of customer experience for all users of the ADSL network during the forthcoming regulatory period. In particular, Telstra considers that the ACCC proposal has the following implications:

- It represents a further departure from price stability, which is in the Long Term Interests of End-users (**LTIE**). Deviating from this approach to the extent proposed by the ACCC (45% reduction to AGVC/VLAN pricing), albeit whilst reducing the decrease in prices of the remaining fixed services relative to the prices as set out in the ACCC's Further Draft Decision, will significantly distort the relativities between resale and infrastructure based inputs. Such an outcome will increase the risk of disruptive pre-NBN migrations between different regulated fixed line services (distracting the industry from the critical task of migrating end users to the NBN itself).
- It will impede migration to the NBN, as the pricing structure of AGVC/VLAN capacity will be considerably cheaper than the combined cost of CVC and POI backhaul faced by access seekers as they migrate to the NBN. NBN migration will, therefore, result in a cost increase for wholesale ADSL (**WADSL**) customers. Implementing the ACCC proposal will also increase end user reticence to migrate to the NBN if current fixed line services prices (in this case, broadband internet services) fall relative to NBN-based prices, potentially exposing customers to "sticker shock" and/or welfare loss. The ACCC proposal will also reduce incentives for broadband providers to promote NBN services and accelerate the transition, delaying the benefits of high speed broadband.
- It will make it difficult for Telstra to manage demand responses on the fixed line network, which could lead to a deterioration of customer experience (e.g. if the pricing of WDSL

¹Telstra, *Public inquiry into final access determinations for fixed line services—primary prices, Response to ACCC further draft decision*, 17 July 2015

AGVC/VLAN capacity relative to the other fixed services is reduced, WDSL demand is expected to increase, potentially leading to network congestion and lower service quality).

- It calls into question the appropriateness of the demand and expenditure forecasts underpinning pricing, and whether these forecasts are consistent with the Fixed Principles. The ACCC does not appear to have considered how such a significant change in pricing for one service might affect demand and expenditure requirements. Rather, the ACCC has assumed that the impact of a change in AGVC/VLAN pricing will have a negligible impact on demand, network congestion, and the costs Telstra would reasonably be expected to incur. This is an unreasonable assumption, given the magnitude of the proposed price change.
- It omits consideration of relevant additional expenditure that will likely be incurred by Telstra if the ACCC's revised pricing proposal is implemented. Whilst the ACCC states the overall revenue requirement recoverable by Telstra will not change under this proposal, the ACCC does not consider that Telstra would likely need to increase investment in its network to maintain current quality levels, amongst other things, given the incentives created by the changed price relativities. In the short time allowed for submissions, Telstra has not had an opportunity to properly analyse the potential impact of the proposed price change on demand and investment requirements. However, given the significance of the proposed price change, it is likely that such impacts would be material. Telstra considers that it would be unreasonable for the ACCC to proceed with its proposal without proper consideration of the potential consequences on cost and/or customer experience and congestion.

Telstra would be pleased to discuss these issues further with the ACCC, however, we also recognise that the general process must be drawn to a conclusion quickly.

2. Price stability (and minimizing distortion of price relativities across all fixed services) will best promote the LTIE

Telstra recognises that over the next FAD period, there are likely to be significant challenges faced by access seekers driven by changing consumer usage patterns and the WDSL two part tariff. This was recognised in Telstra's July 2015 response to the ACCC information request,

“Under the proposal to smooth any change in FAD prices through an equi-proportional change to all regulated fixed lines services, the next FAD will maintain the current price relativities between WDSL port and AGVC/VLAN charges. However, due to the forecast change in demand for WDSL SIOs and AGVC/VLAN bandwidth (with SIOs declining relative to bandwidth), the proposition of the revenue requirement recovered from either port charges or bandwidth charges will change significantly over the period to FY 2019.

Given this change in the relative demand for the services, WDSL access seekers will face a very different cost structure for the recovery of the revenue requirement over the next FAD, if current price relativities for port and AGVC/VLAN charges are maintained.”²

However, Telstra and the ACCC³ agree that maintaining price stability across the fixed line services will promote the LTIE and best support a successful migration to the NBN. Reducing AGVC/VLAN to the extent proposed by the ACCC is sub-optimal and will result in unintended consequences which will not benefit the LTIE.

- First, reducing AGVC/VLAN pricing to the extent proposed by the ACCC (45% reduction when compared with current prices) whilst maintaining the relativities of the remaining fixed services will significantly distort the relativities between resale and infrastructure based competition. Such an outcome will increase the risk of disruptive pre-NBN migrations between different regulated fixed line services (distracting the industry from the critical task of migrating end users to the NBN itself).
- Secondly, the ACCC's proposal will impede migration to the NBN, as the pricing structure of AGVC/VLAN capacity will be considerably cheaper than the combined cost of CVC and POI backhaul faced by access seekers as they migrate to the NBN. Implementing the ACCC proposal will increase end user reticence to migrate to the NBN if current fixed line services prices fall relative to NBN-based prices, potentially exposing customers to “sticker shock” and welfare loss. The ACCC proposal will also reduce incentives for access seekers to promote NBN services and accelerate the transition delaying the benefits of high speed broadband.

These are discussed in detail below.

2.1 Reducing the AGVC/VLAN capacity by 45% will distort the relativities between resale and infrastructure based competition

Telstra consider that a final price decision that supports price stability (and minimises variation in price relativities) is in the LTIE. As Telstra has stated previously:

² Telstra, *Response to ACCC information request, ACCC's fixed line services final access determination inquiry: request for further information*, 28 July 2015

³ The importance of price stability as a guiding basis has been long accepted as necessary to achieve the LTIE. As stated in the ACCC's Final Report on the FAD for wholesale DSL (ACCC, *Public inquiry to make a final access determination for the Wholesale ADSL service*, Final Report, Public Version, May 2013, pg. 49:

“The ACCC considers that applying a uniform price change to all declared services and maintaining price relativities will minimize any undesirable consequences of setting prices for individual services using the current approach. The ACCC considers that the uniform price change will provide stability to the industry in the transition to the NBN. This will minimize incentives for access seekers to change the way they provide services to end users and allow for continue efficient use of infrastructure already in use, which will in turn promote efficient use of declared services. It will also avoid any adverse impacts on competition from changing price relativities.

“Were the ACCC to set pricing that significantly changes the price relativities in this manner, this will likely result in a responsive shift in demand (i.e. intra-migration of wholesale fixed line services). Pre-NBN intra-migrations due to significant changes in price levels and relativities would be contrary to the LTIE as it would risk:

- *Leading to service disruptions whilst technology cutovers occurred for no end benefit to the end-user (as there would be no improvements to speed or service quality achieved by migrating between legacy based technologies simply because an access seeker was seeking lower input costs);*
- *Resulting in unnecessary and costly disruption to the wholesale and retail fixed line services markets during the transition to the NBN;*
- *Deterring investment in, and use of, infrastructure-based services (which could also de-stabilise past investments) if there are significant decreases in resale prices relative to ULLS and LSS pricing;*
- *Shifting the industry’s focus away from the NBN migration to intra-migrations on the legacy network and, hence, distract industry players from the investment and innovation in relation to the transition to a competitive NBN model; and*
- *Making it difficult for Telstra to manage demand responses on the fixed line network which could lead to a deterioration of the end user experience (e.g. if the pricing of WDSL relative to the other fixed services is reduced, WDSL demand is expected to increase, potentially leading to network congestion and lower service quality).⁴*

Maintaining price stability and minimising distortions in price relativities between infrastructure based and resale inputs will best promote the LTIE. Telstra considers that the ACCC proposal may encourage the intra-migration of wholesale fixed line services in the short term. The sharp decline in the price of AGVC/VLAN capacity as contemplated by the ACCC proposal could result in access seekers abandoning their infrastructure based investments in favour of resale competition in certain areas ahead of the NBN. In such cases, there will be no commensurate benefit for end users. Further, such an activity would likely result in duplicated industry efforts at a time when complete focus should be on migrating customers to the NBN and on competition in the NBN world. Finally, the ACCC proposal will destabilise sunk investment in infrastructure by access seekers as the ACCC proposal risks accelerating the write down of investments resulting in economic loss.

2.2 The ACCC proposal will impede NBN migration

2.2.1 There are stark differences between WDSL and NEBs

Telstra considers that the ACCC proposal will impede migration to the NBN, as the price levels of AGVC/VLAN capacity will be considerably cheaper than the combined cost of CVC and POI backhaul faced by access seekers as they migrate to the NBN. Whilst both wholesale DSL and the NBN Ethernet Broadband service (**NEBs**) are Layer 2 broadband services, there are distinct differences which the ACCC should consider in determining whether to implement its revised pricing proposal. Telstra considers that setting AGVC and CVC prices at near identical levels (the ACCC propose to price AGVC/VLAN capacity at \$17.90 per Mbps per month whilst CVC is priced at \$17.50 per Mbps per month⁵) will impede the transition to the NBN.

The NEBs is sold in a more disaggregated fashion than Wholesale DSL. Access seekers need to purchase an Access Virtual Circuit (**AVC**) per end user, and a Connectivity Virtual Circuit (**CVC**) for each connectivity service area they wish to supply retail services to. Conceptually, this is similar to the Wholesale DSL model where access seekers purchase a port per end user, and AGVC/VLAN

⁴ Telstra, *Public inquiry into final access determinations for fixed line services—primary prices Response to Discussion Paper*, 3 October 2014, Public version, pg. 8

⁵ NBNC Co Wholesale Broadband Agreement Price List v2.3B, pg. 6

capacity. However, under the NBN model, the CVC is handed over to the access seeker at one of 121 points of interconnect (**POI**) which are distributed nationally, whereas the WDSL model hands the VLAN over to access seekers in 7 capital cities. In order for an access seeker to then connect their NBN traffic to their own core network they will need to incur additional costs in either building or buying backhaul transmission from each of the 121 POIs that they wish to serve back to their core network location which is usually located in capital cities.

The consequence of this would be that wholesale ADSL customers face substantially lower usage based prices for ADSL than they will for NBN once they migrate their services.

2.2.2 Implementing the ACCC proposal will result in end user reticence in migration, “sticker shock” and welfare loss

Maintaining price stability and minimising distortion in price relativities will lessen “sticker shock” and maintain overall economic welfare as customers migrate to the NBN. Substantial reductions in AGVC/VLAN capacity pricing could set unrealistically low expectations of the cost of broadband (particularly in regional areas where WDSL take up is more significant) exposing customers to “sticker shock” with the implication that as NBN services become available, customers will be more likely to delay migrating to the NBN than would otherwise be the case. The ACCC proposal will result in the legacy service being priced in a manner that is more attractive than the equivalent NBN service, ultimately impacting the transition to the NBN. Such an outcome was observed in New Zealand where the Commerce Commission reduced the regulated price of legacy broadband by 50%, making the legacy based service more attractive relative to the fibre broadband service. Alternatively, the ACCC proposal could result in access seeker’s “banking” the resulting margin increase ahead of migration to the NBN, without bestowing any commensurate benefit to end customers. Neither of these outcomes would promote the LTIE.

The retail price differential between NBN-based services and copper-based services is an input into consumers’ decisions as to when to migrate. Analysis of the current competitive landscape shows most players are generally pricing NBN services at parity or better than legacy services, aiding a smooth transition between the technologies. The current retail pricing has contributed to a steady upward trend in the percentage of serviceable NBN premises being connected. Assuming access seekers were to pass on the full reduction of the ACCC proposal to end users, the result of the ACCC’s proposed price reduction to \$17.90 for AGVC/VLAN capacity means that as access seekers move to the NBN, the input costs for delivering a service to end users will rise and could require a price rise for consumers. Telstra cautioned against such an approach in its October 2014 submission, where it stated

“...stable price path through a modest nominal increase will also avoid potential sticker shock as customers migrate to the NBN. significant reductions in legacy service pricing could create unrealistically low expectations of the value of broadband, with the implication that when NBN services become available to customers they will either delay migrating to the NBN or choose not to. The “sticker shock” effect could also skew the take-up of NBN products more towards the lowest-value entry level options than would otherwise have been the case.”⁶

The ACCC should consider the real possibility that access seekers may not in fact pass any or all of the proposed reductions in AGVC/VLAN capacity price through to end customers. In setting retail prices in the market, RSPs need to consider a range of factors and access price is simply one consideration. In this context and given the changed and more challenging economics under the NBN, it is possible that access seekers may in fact simply “bank” the margin differential resulting in an economic transfer, which does nothing to promote the LTIE. Worse, customers may still suffer a degraded customer experience due to congestion problems (discussed in greater detail in Section 3). Such an outcome is not in the LTIE.

⁶ Telstra, *Public inquiry into final access determinations for fixed line services—primary prices Response to Discussion Paper*, 3 October 2014, Public version, pg. 126

2.2.3 Access seekers will lack incentive to migrate customers to the NBN delaying the benefits of the NBN

Implementing the ACCC proposal will also reduce incentives for broadband providers to promote NBN services and accelerate the transition. The incentives of RSPs to promote NBN services are directly affected by the wholesale fixed line services pricing and the price relativities between all of the fixed line services.

NBN itself has highlighted significant concerns about the effect the ACCC's FAD will have on a delayed migration. As NBN has stated in the context of the ACCC's Further Draft Decision which proposed a uniform 9.6% price decline across all services, this price drop "... is expected by nbn to lead to a slower rate of migration to the nbn™ network within the 18 month disconnection window. This would be an unfortunate and unexpected outcome, particularly given the ACCC's previous statements on ensuring a smooth transition to the nbn™ network."⁷ The decline in prices (particularly for AGVC/VLAN capacity) contemplated by the ACCC will only further complicate this and further delay migration to the NBN network.

Changing the price relativities to the extent proposed will also discourage access seekers from promoting migration to the NBN network. As such, the task of migration will become even more challenging if prices of existing copper network services fall and relativities alter to the extent proposed by the ACCC proposal. The result would be a surge in migrations or disconnections immediately prior to the copper cutover. This impact will make it less likely that copper cutover timeframes can be met, and will cause logistical problems, additional cost and customer frustration. A smoother customer migration (supported by access seekers) would be expected under a FAD determination if price variation was limited and distortions between fixed services were minimised.

3. Lower AGVC/VLAN prices will exacerbate issues of ADSL network congestion

Telstra's ADSL network is a congestible network – that is, as one end user increases their traffic consumption, other users' experience is impacted.⁸ There is a strong relationship between price, congestion and customer experience.⁹ A lower AGVC/VLAN price relative to other fixed services may induce more demand (by encouraging access seekers to offer larger data allowances or unlimited allowances to customers at peak periods), resulting in more network elements becoming congested sooner than otherwise. Telstra considers that the ACCC's proposal will necessarily result in a responsive shift in demand that could lead to a deterioration of customer experience through network congestion. Such an outcome is not in the LTIE.

Further, the proposed reduction in AGVC/VLAN prices will mean prices will not reflect the economic cost of the service, which should account for any congestion externality. Gowrisankaran and MacKie-Mason conclude that "if congestion for Australian ADSL services is under-priced relative to the social optimum, the market for Australian ADSL will not shut down, but rather it will deliver fewer benefits than under optimal congestion pricing".¹⁰ For the reasons explained in their report, significant reductions in the AGVC/VLAN price of the order proposed by the ACCC will not be in the LTIE.

To mitigate congestion, Telstra has invested substantially in the ADSL network and faces ongoing demand for further investment over the upcoming FAD period. The forecast capital spend for Data Equipment over the FAD period in the FLSM is [Commercial in confidence commences] [Commercial in confidence ends]. Telstra has previously submitted extensively on congestion and the impact WDSL pricing would have on this.¹¹ Telstra has previously managed congestion

⁷ NBN, *Public inquiry into final access determinations for fixed line services-primary price terms- Further Draft Decision*, 28 July 2015

⁸ Telstra WDSL Price Submission August 2012 in response to ACCC issues paper, WDSL FAD inquiry

⁹ Ibid.

¹⁰ Gowrisankaran and MacKie-Mason, "Efficient Pricing of ADSL Wholesale services", 23 August 2012.

¹¹ See for example Telstra, *Response to the Commission's Issues Paper (a second discussion paper) into the public inquiry to make a final access determination for the wholesale ADSL service:*

through the investment in the backhaul transmission systems that carry traffic between the ADSL network elements – DSLAMs, BRAS, and IGRs. In the interim period ahead of full NBN transition, decisions regarding whether (and where) to undertake incremental investments to relieve congestion will become further complicated. As Telstra has previously outlined to the ACCC, such investment decisions are difficult, since Telstra often invests to relieve congestion and improve the customer experience, even though the incremental return is very low (that is, growth in demand for broadband data significantly outpaces growth in revenues for broadband services). This will be further complicated in an NBN context, where investment returns may never be fully realised given the short payback period available.

Where additional congestion does occur, it will be felt by both retail and wholesale ADSL customers on Telstra's ADSL network. The network is a shared network, with wholesale and retail traffic carried on common transmission infrastructure between DSLAMs, BRAS and IGRs.

In the time allowed for submissions, Telstra has not had an opportunity to fully analyse the potential impact of the proposed price change on demand and network congestion. However, given the magnitude of the proposed price change, Telstra expects that that these impacts would be material. In these circumstances, Telstra considers that it would be unreasonable for the ACCC to proceed with its proposal without proper analysis of these likely impact, and without allowing stakeholders sufficient time to make informed submissions.

4. The ACCC proposal omits consideration of additional cost Telstra will incur as a direct consequence of the ACCC proposal

As detailed in Telstra's July 2015 response letter, Telstra remains concerned that should the ACCC implement its proposal in relation to revised pricing for AGVC/VLAN capacity, it will do so in isolation of other inter-related impacts.

As Telstra stated in its July 2015 response letter to the ACCC,

"Telstra is concerned that the ACCC's request may result in irrelevant and inconsistent information being taken into account in the setting of access prices. Specifically, FY2015 demand for retail and wholesale ADSL will be necessarily inconsistent with the other cost and demand information that serve as inputs to the FLSM (and which are based on FY2014 as a base year)."¹²

For example, implementing the ACCC proposal would likely result in different capital and operating expenditure, and changes in demand for other services which would necessarily impact on the overall revenue requirement. The ACCC's proposal assumes that the impact of a change in AGVC/VLAN price and demand will have negligible impact on other services or costs Telstra would reasonably be expected to incur. This is an unreasonable assumption, given the magnitude of the proposed price change. It is also incorrect, as the investment and costs associated with the assets used to supply backhaul capacity are elastic to price and demand. A 45% lower AGVC/VLAN price will result in additional demand, which will require additional investment to meet that demand.

As discussed above, in the time allowed for submissions, Telstra has not had an opportunity to fully analyse the potential impact of the proposed price change on demand and network expenditure requirements. However, given the magnitude of the proposed price change, Telstra expects that that these impacts would be material. In these circumstances, Telstra considers that it would be unreasonable for the ACCC to proceed with its proposal without proper analysis of these likely impact, and without allowing stakeholders sufficient time to make informed submissions.

Pricing to Improve Customer Experience, 24 August 2012; Telstra, Response and Further Submission on ADSL Congestion, 16 November 2012, Gowrisankaran and MacKie-Mason, "Efficient Pricing of ADSL Wholesale services", 23 August 2012

¹² Telstra, *Response to ACCC information request, ACCC's fixed line services final access determination inquiry: request for further information*, 28 July 2015