TELSTRA CORPORATION LIMITED

Submission to the Australian Competition and Consumer Commission

Telstra Response to "*Fixed Services Review: Further Consultation on draft ULLS pricing principles*" of October 2007

November 2007

Introduction

Telstra refers to the Commission's "*Fixed Services Review: Further Consultation on draft ULLS pricing principles*, October 2007".

Set out below are Telstra's further submissions in relation to the draft ULLS pricing principles contained in the Commission's ULLS declaration decision.[1]

Pricing methodology for network costs

In setting the pricing principles for ULLS, the Commission is required to balance the matters set out in section 152AH of the *Trade Practices Act* 1974 (**"TPA"**) and give fundamental weight to each of them. In the ULLS context, these matters include:

(a) the long term interests of end users (**"LTIE"**) of ULLS, which in turn requires that regard be had to the objective of encouraging efficient investment in ULLS infrastructure;[2]

(b) the legitimate business interests of Telstra, and Telstra's investment in facilities used to supply ULLS[3]; and

(c) the direct costs to Telstra of providing access to ULLS[4].

Telstra notes the Commission's view that:

> *Consistent with its previous views, the Commission considers that TSLRIC is the appropriate pricing principle for the establishment of prices for the ULLS and PSTN OTA. In all cases the Commission has adopted a TSLRIC+ approach to the pricing of these services.*[5]

TSLRIC+ refers to the scope of the relevant costing, for example, it refers to the total service, the long run, and the increment of the cost. Within this definition, Telstra agrees that TSLRIC+, properly applied, may be an appropriate principle to apply for pricing the ULLS. Although TSLRIC+ defines the scope of the costing exercise, it does not define the method of valuing the inputs into the supply of the regulated service (for example, capital, O&M, indirect costs etc). Telstra submits that this is an important element of the Commission's task in setting ULLS pricing principles. In determining an appropriate valuation approach, the Commission should have regard to the quality of the data that is available for valuation (ideally valuing inputs using the most accurate network data and appropriate engineering rules). For example, if there is a lack of reliable data relating to what assets are required to supply the service or the engineering rules used to provision the network, then the risk of

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[1] Commission, *Declaration inquiry for the ULLS, PSTN OTA and CLLS-final decision*, July 2006.

[2] Section 152AH(1)(a) of the TPA.

[3] Section 152AH(1)(b) of the TPA.

[4] Section 152AH(1)(d) of the TPA.

errors in "bottom-up" or hypothetical cost modeling is large. In those circumstances it may be appropriate to use a "top-down" TSLRIC+ cost model which relies upon the actual cost of providing the service, and to have close regard to international benchmarks. On the other hand, if there is reliable data available with which to model costs, the risk of error in cost modeling is reduced. In those circumstances it can be appropriate to place more reliance upon bottom-up cost models..

Pricing ULLS below the cost of supply has led to a reduction in customer access network investment by Optus and Telstra

In determining pricing principles for ULLS, the Commission should have regard to the impact of previous pricing principles and price determinations on infrastructure investment, and adjust its approach accordingly. Regulation of wholesale products such as ULLS and LSS exists to promote long-term competition within the industry. However, the current level of pricing of regulated products such as ULLS and LSS is distorting 'build versus buy' incentives in Australia. As wholesale prices have fallen in recent years, investment in alternative end-to-end networks (in particular competitors' HFC networks) has been minimal. The HFC network owned by Optus has seen little expansion since the late 1990s, and Neighbourhood Cable's network has not been expanded since 2003.[6]

Rather than investing in the expansion of their own end-to-end networks, most carriers have chosen to use Telstra's regulated wholesale products. Moreover, even if there are other reasons to explain the lack of expansion of HFC networks, there is evidence to suggest that even in areas where carriers have already deployed their own end-to-end networks, they are electing to use Telstra's wholesale services instead.

Figure 1 below shows that on a national level, Optus' use of Telstra wholesale products to provide retail broadband has been increasing relative to its use of HFC since mid-2004 - Optus now has more DSL broadband customers than cable broadband customers. Moreover, while its use of Telstra's wholesale products to provide voice has been on the rise, Optus' use of its own HFC to provide voice has been declining in absolute terms. It is immediately apparent from this graph that Optus' reliance on its own facilities is in relative decline.

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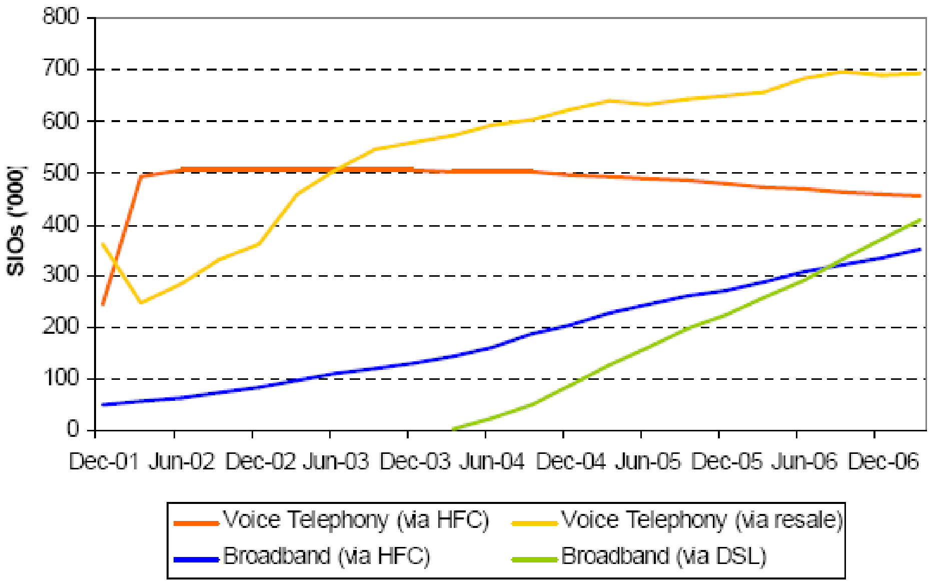
[5] Commission, *Declaration inquiry for the ULLS, PSTN OTA and CLLS-final decision*, July 2006 page 55.

[6] Public information on Neighbourhood Cable's website (http://www.ncable.net.au/_site/about.asp?cat=19) indicates that their last rollout was completed in 2003 and there have been no rollouts since then.

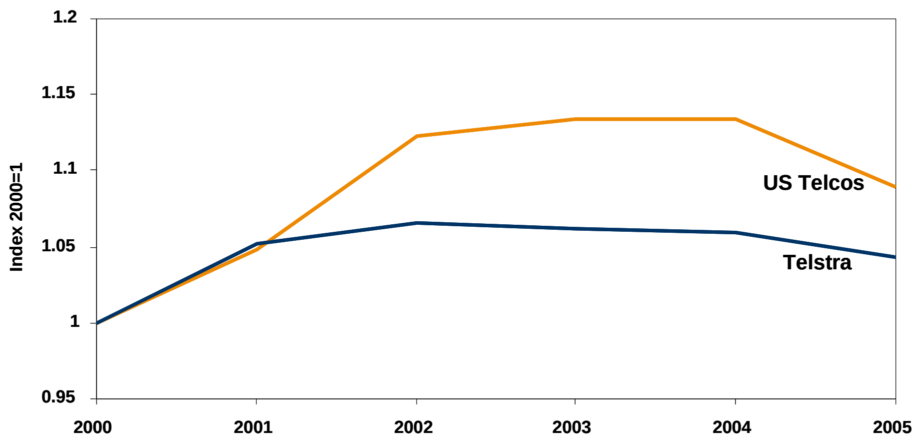
Figure 1: Optus' use of HFC and Telstra Wholesale services



Source: Optus Annual Reports and Announcements

Reduced investment is also evident from the capital stock comparison between Telstra and the US (Figure 2). Between 2000 and 2005, the size of Telstra's capital stock has fallen relative to US telecommunications companies.

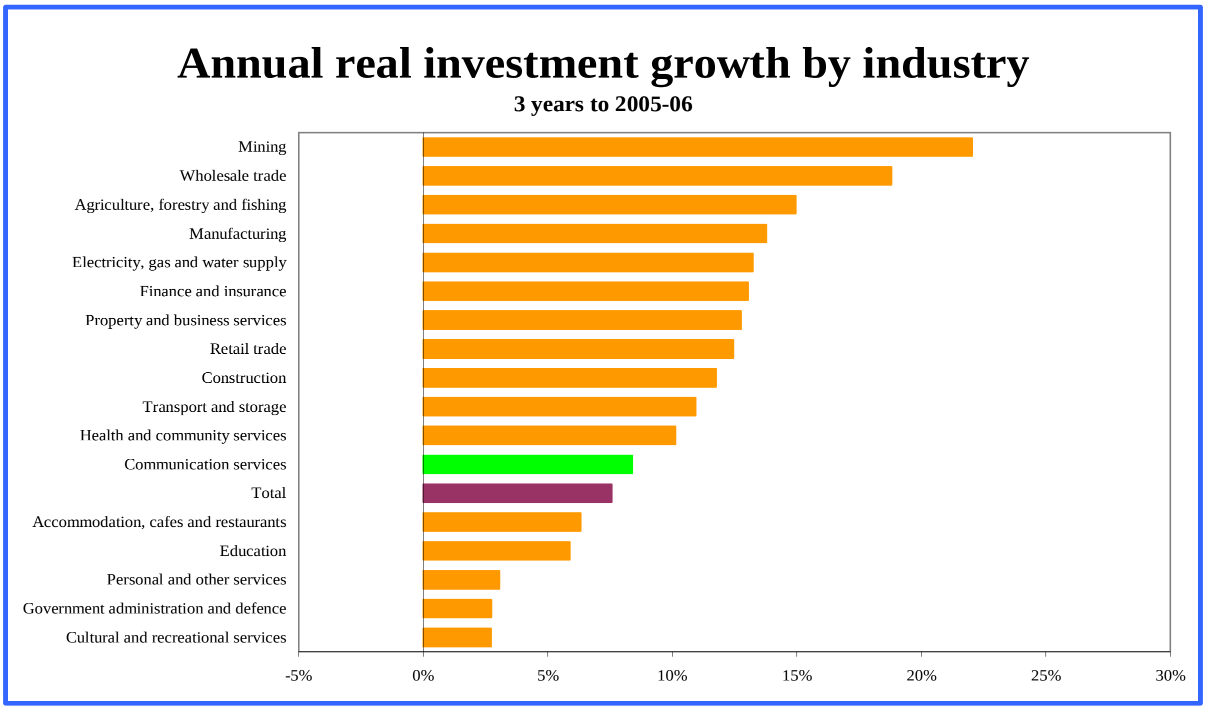
Figure 2: Capital stock employed by Telstra and five large telecommunication firms in the US



Source: ARMIS database (includes capital stock for BellSouth Corporation, AT&T Inc, Qwest Corporation and Verizon Communications); Telstra Annual Accounts; ABS.

Further, the rate of investment in the Australian communications industry has lagged significantly behind the rate of investment in other industries, including highly regulated industries such as gas and electricity (Figure 3).

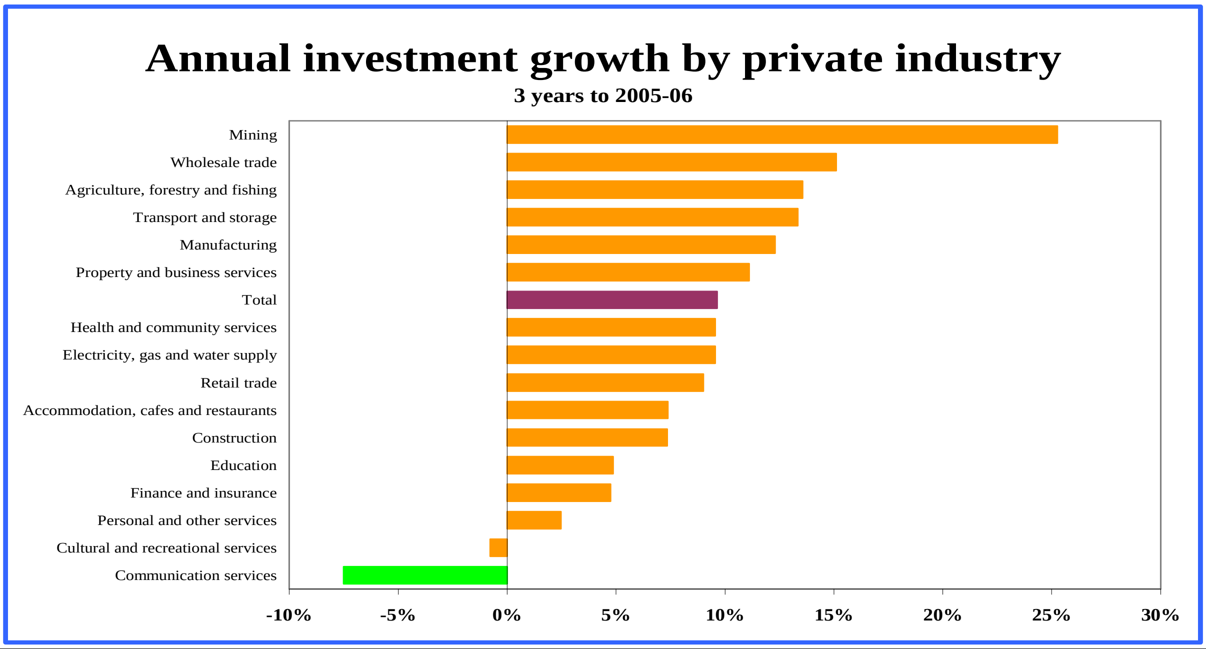
Figure 3: Annual real investment growth by industry



Source: Australian Bureau of Statistics[7]

More importantly, annual investment growth by the private sub-component of the communications sector (excluding Telstra up to 2005-06) for the same period actually shows a reduction of 7.5 per cent per annum in nominal terms on average, the lowest rate of growth for any industry, and the only industry apart from cultural and recreational services that has contracted over this period of strong economic performance (see Figure 4 below).

Figure 4: Annual investment growth by private industry



Source: Australian Bureau of Statistics[8]

[7] Australian Bureau of Statistics, *Australian System of National Accounts, 2005-06*, Catalogue number 5204.0, 1 November 2006, table 91

The above evidence indicates that regulated prices for wholesale telecommunications services are being set too low by the Commission, contrary to the LTIE. Accordingly, the Commission should determine pricing principles for ULLS which will ensure that the trend towards disinvestment in telecommunications infrastructure in Australia does not continue.

The Commission should not set prices where there is competitive infrastructure

Due to the impacts on infrastructure investment described above, the Commission should consider not setting prices on a TSLRIC basis in areas where there are alternative fixed-line networks such as the fibre networks in CBD areas and the Optus HFC network in metropolitan areas.

In areas where alternative networks exist, access to the ULLS at TSLRIC+ based prices clearly create an incentive for Telstra's competitors simply to rely on ULLS resale instead of making efficient investments in alternative networks.

Alternatively it should consider differential pricing arrangements in areas where alternative networks exist.

ULLS pricing principles must take account of high-cost areas

ULLS prices must enable Telstra to recover the losses it incurs in supplying access services to high-cost rural areas. Those losses are incurred as a result of the retail price parity obligations, and the fact that the Universal Service Fund fails to provide Telstra with adequate compensation for those losses. Telstra favours a ULLS price based on a geographically averaged cost of supplying the ULLS to achieve this. Averaged ULLS prices:

(a) are consistent with the principles applied by the Commission in determining access to other services. In the Access Dispute between Services Sydney Pty Ltd and Sydney Water Corporation ("Sydney Water"),[9] the Commission as recently as June this year recognised that if access seekers failed to make a contribution to 'postage stamp pricing' (the requirement to provide uniform prices at the retail level), that this would *distort* the market, gradually *unwind* the effective, universal provision of the service, and *disadvantage* the access provider and the end-users of the service;[10]

(b) are consistent with the recommendations of the OECD:

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[8] Australian Bureau of Statistics, *Australian System of National Accounts, 2005-06,* Catalogue number 5204.0, 1 November 2006, table 64.

[9] Access Dispute between Services Sydney and Sydney Water Corporation, Arbitration Report and Statement of Reasons ("**Sydney Water**") .

[10] Commission, Sydney Water, pages 42-45.

"In regard to geographic differentiation of prices, as before, if the scope for competition is to be maximised and if end-user charges are to be preserved, the structure of access charges should reflect the structure of the end-user charges. If end-user prices are geographically averaged, and ULL 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.

If the regulator wishes to preserve the geographically averaged structure of end-user prices, it is essential to geographically average ULL prices;[11]"

(c) are consistent with Australian Government policy that rural customers should be treated the same as urban customers;[12]

(d) are consistent with numerous international precedents;[13] and

(e) are consistent with the criteria set out in s 152AH of the TPA. This is because, among things, they promote competition on the merits by allowing Telstra to compete with access seekers on the basis of Telstra's own efficiencies.

Telstra notes that the Australian Government is currently conducting a review of the Universal Service Obligations. Telstra acknowledges that should the Universal Service Fund provide it with adequate compensation for the losses it incurs in rural areas, prices may be deaveraged.

The technical limits imposed by the service description of ULLS must be considered

As noted in Telstra's September 2006 submission[14], services supplied by access providers are defined by the technical limits of their service description. These limits must be recognised in cost determinations, if prices are to bear any relation to the efficient cost of supply.

ULLS involves the use of unconditioned copper pairs between the network boundary at an end-users' premises and a point (at a customer access module) at which the copper terminates.[15] ULLS cannot be provided using other technologies such as wireless or fibre optic connection. Therefore the price of ULLS cannot be determined based on the cost of

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[11] OECD, *Access Pricing in Telecommunications*, 2004, page 134.

[12] For example, Media release, Line Rental Parity for Rural Australia enshrined in Price Controls, Senator the Hon Helen Coonan Minister for Communications, Information Technology and the Arts dated 28 February 2006 : "*[Telstra's retail price control] reaffirms this Government's commitment to retail pricing parity for the benefit of all Australians, especially those living in regional, rural and remote areas of the country.*"

[13] *MCI Telecommunications Corp. v. GTE Northwest, Inc.*, 4lF. Supp.2d 1157, 1170-71 (D.Or.1999); *In Re Qwest Corp.*, Docket No. RPU-00-1 (TF-00-64) Final Decision & Order, Iowa Util. Bd. at 28-29 (Jan 11, 2001); *In re AT&T Commun. of the Mountain States, Inc.*, 1999 WL 561629, at *17 (Wyo.Pub.Serv.Com'n March 22, 1999); *In Re AT&T of New England* Docket No. 96-510; 1996 WL 773533, at *74 (Me. Pub. Util. Com'n Dec. 4, 1996); *In Re Sprint* No. 96-1021-TP-ARB; 1996 WL 773809 (Ohio PUC 1996).

[14] Telstra's 2006 Submission, paragraph 16.

[15] Commission, *Declaration inquiry for the ULLS, PSTN OTA and CLLS-final decision*, July 2006 page 11.

providing services using non-copper based technologies. Such an approach would be illogical and contrary to the statutory criteria. The price of apples cannot be used to price oranges.

Specific costs

All specific costs due to the ULLS, should be recovered from the users of the service and not another service. Any other allocation of costs is contrary to the Commission's consideration of the direct costs of the declared service (that is ULLS).

Connection/disconnection costs

Telstra does not object in principle to the use of TSLRIC+ pricing principles for determination of ULLS connection and disconnection charges. However, it is critical that TSLRIC+ pricing principles are applied appropriately to ensure that the long-run incremental costs of all aspects of provisioning and de-commissioning the ULLS are captured.

Telstra's arguments above in support of averaged pricing apply equally to connection and disconnection charges.