



**FINAL ACCESS DETERMINATION: THE
DOMESTIC TRANSMISSION CAPACITY
SERVICE
ACCC PRICING INQUIRY**

Submission on the October
expert reports of Professor
Breusch and CEG

PUBLIC VERSION

2 December 2015



This short submission supplements our submission on the ACCC's draft final access determination (**FAD**) for the Domestic Transmission Capacity Service (**DTCS**), dated 4 September 2015 (**draft FAD**) and Economic Insights' (**EI**) final report on the DTCS benchmarking model, dated 1 September 2015 (**Final Report**). VHA and Professor Bartels, the expert it has retained, have now had an opportunity to consider the expert reports prepared by Professor Trevor Breusch, dated 2 October 2015 (**Breusch Report**) and CEG, dated October 2015 (**CEG Report**) and wishes to comment upon some issues that were raised in those reports.

This submission should be read in conjunction with the **Attachment**, which is a further report from Professor Robert Bartels addressing some specific aspects of the Breusch Report (**November 2015 Bartels Report**).

1 2Mbps services

VHA has repeatedly emphasised the importance of finalising the FAD process as quickly as reasonably possible. The pricing observations upon which EI's modelling is based are now more than two years out of date and in most cases probably substantially more. Consultation on DTCS pricing commenced in 2014 with the release of the ACCC's position paper on 24 July of that year and now looks set to continue into 2016. In the meantime, any benefits that could be expected to accrue from the ACCC's FAD are quickly eroding.

In this context, VHA is not convinced that exclusion of 2Mbps services, as proposed in the CEG Report, is warranted at this late stage. Rather, it is likely that any potential benefit will be outweighed by the detriments to competition and efficiency arising from even further delay in making a cost-reflective FAD.

The possibility of excluding 2Mbps services was canvassed by Professor Bartels in his report, dated 22 April 2015, prior to the stakeholder workshop and EI commencing work on its draft model. At that early stage in the process, it would have been feasible and perhaps even advisable to adopt an approach whereby 2Mbps services were separately modelled. However, the ACCC (or EI) chose not to do so.

By contrast, excluding 2Mbps services at this late stage in the process:

- would require re-estimation of the benchmark model;
- necessitate extensive consultation on new models; and
- is likely to substantially delay the finalisation of the FAD process and add to stakeholder costs.

2 Optus/VHA eJV data

If, contrary to VHA's position, the ACCC forms the view that re-estimating the model without 2Mbps services is unavoidable, it is essential that the eJV data be incorporated at the same time. To do otherwise in these circumstances would be arbitrary and unsound given that the model will need to be re-estimated in any event.



As the November 2015 Bartels Report indicates, the eJV data contains a significant number of observations (more than █% of the combined data set).

The ACCC's stated aim is to determine regulated prices on declared routes that approximate the operation of a competitive market. The eJV data represents commercially negotiated prices and amounts to a significant proportion of the overall market for transmission services.

Professor Breusch points to bundling and uncertainty about whether the eJV data represents competitive pricing as reasons for not including the data in the benchmark model. However, these considerations are also applicable for many of the observations that make up the current data set. Professor Bartels has previously opined on the extent of bundling in the current data set and the challenges that this presents for a regression. If this was not a basis for excluding observations from the current data set, it cannot form a basis for excluding the eJV data now.

Similarly, while it is true that eJV pricing forms part of a broader deal between Optus and VHA, this is a common industry practice. Modular wholesale agreements such as Telstra's Customer Relationship Agreement and the Telstra Wholesale Agreement typically represent a deal across a range of services of which transmission capacity will be only one.

Accordingly, if the ACCC were to exclude this data from the modelling (without otherwise reflecting it in the terms of the FAD), this would produce unjustifiably selective results.

Professor Bartels concludes that the credibility of the benchmarking process will be seriously undermined if the ACCC fails to take into account the eJV data in its model. While the ACCC may be able to take account of the data in the exercise of its regulatory discretion without requiring that EI re-estimate the benchmarking model (for example by deciding to move towards a frontier approach) it is clear that if it instructs EI to re-estimate the model for another reason, the eJV data must be included.

3 Dynamic pricing

Regardless of when the FAD is released, the failure of the draft FAD to address changes in pricing over time must be rectified. Taking a conservative approach, it is reasonable to assume an annual decrease in commercially negotiated prices on exempt routes of 10% per annum. As a consequence, depending on when prices in the 2014 data set were actually negotiated, prices are likely to be more than 20% above competitive prices when the FAD commences in 2016 and around 65% higher than competitive prices when it expires in 2019.

VHA accepts that there may not be a statistical technique for determining precisely what the quantum of the decrease may be in any given year. However, the information before the ACCC demonstrates clearly that significant decreases in price are observable year on year. In this context, it would be entirely inconsistent with the ACCC's statutory task to decide against including some form of productivity adjustment factor into its FAD to address this.

Ultimately, determining the quantum of the productivity adjustment factor is a regulatory decision that falls to the ACCC and, regardless of whether the ACCC implements a downward glide path in its FAD, a decision on the issue is unavoidable. In its draft FAD, by choosing not to reflect changes to pricing over time, the ACCC has chosen to set the productivity adjustment factor at one. To put it another way, it has chosen to adopt an assumption that there will be no



change in non-declared prices over time. VHA submits that this decision is manifestly unreasonable in the context of the information currently before the ACCC and the statutory criteria it must apply.

The certain consequence of the ACCC's proposed approach is regulated prices that will be substantially above commercially negotiated prices on exempt routes with the same characteristics throughout the term of the FAD.

VHA would be happy to discuss any of the issues raised in this letter with you further if it would assist.



Attachment

19 November 2015

By email

Mr Thomas Jones and Ms Jennifer Dean
Corrs Chambers Westgarth
8-12 Chifley Square
Sydney NSW 2000

Confidential and privileged

Dear Thomas and Jennifer

I refer to your email of 12 November 2015 in which you ask me to express my views on several issues discussed in Professor's Trevor Breusch's report of 2 October 2015 (**Breusch Report**) on Economic Insights' Final Report (**EI Report**) and the ACCC's draft Final Access Determination (**Draft Decision**) for Domestic Transmission Capacity Services. I deal with each of these issues in turn.

- 1) Professor Breusch's conclusions about the treatment of changes in prices over time at paragraph 3.6 including his statement that there is a "*lack of information to provide a robust empirical basis for specifying a productivity adjustment factor*"

There is broad acceptance among participants in the market that DTCS prices are trending down. Several estimates have been made of the rate of decline in prices. Using regression analysis of the combined 2011 and 2014 datasets, EI estimated that "annual charges declined by approximately 10 per cent per year on the deregulated routes" and found that the rate of change was "highly statistically significant" (EI's Report p.33). A more direct, intuitive, consideration is that the average price for services on deregulated routes declined by almost 30% between the 2011 and 2014 datasets. This is despite the fact that the average speed of services almost tripled, and the average distance increased by more than 20%. It is safe to say that a comparison of equivalent services between the two datasets would show a price decrease of at least 30% over the period. Hence a conservative estimate would be that deregulated prices have decreased by about 10% per year.

Model 1 in EI's Report (pp. 47, 90) provides an estimate of [REDACTED] per year price decline. But we know that this is a gross underestimate, since many respondents did not provide the commencement date at which the current price of a service was determined, but rather when the original agreement was entered into. For many services the commencement date was many years prior to the length of the present contract, and hence much earlier than the dates at which the prices were determined. This has the effect of spreading the price decrease over many more years than actually occurred. Thus the annual rate of decline in prices according to this model is well above [REDACTED] and could well be around 10% as well.¹

I note that the prices in the 2014 dataset are already several years out of date, depending on how long prior to the collection of the data the contracts for the services were negotiated. By the end of the FAD period these prices will be at least 5 years out of date. If deregulated prices continue to decline by 10% per year, as they seem to have done between 2010 and 2014, then by the end of the FAD period, the benchmark prices will be about 65% higher than the deregulated prices.

It is clear that the treatment of changes in prices over time is of crucial importance. In light of the evidence, Professor Breusch's recommendation that the ACCC not specify a productivity factor adjustment, i.e. to adopt a rate of decline in prices of 0%, cannot be justified. The case for specifying a productivity factor of 10% is just as strong if not stronger. Even using a more conservative estimate of future productivity improvement of 5% per year, the benchmark prices will still be almost 30% higher than the deregulated prices.

- 2) whether it is correct to state that the observed outcome whereby the largest provider is also the median one argues against the existence of any residual market power on exempt routes (paragraph 4.2)

Firstly, I note that Professor Breusch is mistaken in his statement that "the smallest providers occupy the most extreme positions on both sides of the median" (Breusch Report, paragraph 4.2). The two smallest providers of exempt services are [REDACTED]

The next smallest provider has [REDACTED] services and is considerably larger.

In its recent report,² CEG indicate that the majority of [REDACTED] outliers. [REDACTED]

[REDACTED] In my view, it is misleading to take these very small providers into account when

¹ Further analysis of the date of commencement data would enable a quantitative correction to be made to the [REDACTED] % figure to correct for the misreporting of the commencement date.

² CEG (October 2015), *Review of the draft decision on DTCS FAD*, p. 9.

determining the median provider. If we ignore these providers, then [REDACTED] which the ACCC has chosen as the benchmark provider, moves from the median position to become the third highest priced provider out of [REDACTED] providers.

However, more relevant is the price gap between the remaining providers. There are two medium-sized providers, [REDACTED] whose prices are, respectively, [REDACTED] [REDACTED] prices. Even after allowing for possible differences in the treatment of GST, that leaves a very substantial gap between [REDACTED]'s prices and the prices of these two medium-sized providers. In my view, this provides *prima facie* evidence that [REDACTED]'s prices are not competitive.

I therefore disagree with Professor Breusch that the finding that the largest provider is also the median provider argues against the existence of residual market power.

3) the concerns identified by Professor Breusch in relation to the inclusion of the eJV data (paragraphs 8.1ff).

The eJV dataset provided to me contains information on [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] Hence it is not possible to assess precisely what impact the inclusion of the eJV data would have on the benchmarking model.

The number of services involved is substantial relative to the original dataset, [REDACTED] compared to [REDACTED] services in the original dataset, which is more than [REDACTED] of the combined dataset.
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] Hence there is a very substantial amount of bundling in the dataset.

The services in the eJV dataset have different characteristics to the dataset used to estimate the benchmarking model. For example, [REDACTED]
[REDACTED]
[REDACTED] In view of this, I agree with Professor Breusch's view that the inclusion of the eJV data in the estimation of the benchmark model is very likely to have a major impact on the model and "that a statistical test of the proposition that the additional data come from the same model as EI has fitted to the existing data [REDACTED]
[REDACTED]"

In light of the above observations, and notwithstanding reservations I have expressed previously about the ACCC's modelling process, I believe that the professional credibility of

the benchmarking process will be seriously undermined if the ACCC fails to take into account the eJV data in its benchmarking model. The fact that this may involve additional modelling work does not diminish the credibility deficit of the current preferred model resulting from the omission of the eJV data.

- 4) the statement by Professor Breusch at paragraph 2.1 that: “*A benchmarking model is required to represent the overall or average relationship between the charge for a service on exempt routes and the observable characteristics of that service. The regulated (maximum) charge on a declared route is obtained by predicting what the charge would be on the counterfactual assumption that it is an exempt route with the same relevant characteristics*” (see also the related statement at paragraph 3.5 about benchmarking “average competitive pricing”)

Professor Breusch makes the implicit assumption that the prices on exempt routes used by EI to develop the benchmarking model are efficient prices determined in competitive markets. The prices used for the benchmarking exercise exhibit characteristics that are plainly incompatible with competitive prices. For example, it is widely accepted that bundling transmission services is common when setting prices, a point highlighted by the eJV data. As I have demonstrated in previous reports submitted as part of the review process, this leads to biased estimates of the parameters in the benchmarking model.

Another indication that many of the prices used to estimate the benchmarking model are unlikely to be competitive is the extremely wide range of unexplained variation in the prices. The standard deviation of the prediction error is roughly 70%. In other words, the prices of comparable services have an extremely wide range around their average value with about 1/3 of the prices being at least 70% higher or lower than the average relationship. It would be hard to think of a truly competitive market with mostly large clients having such a wide range of prices for comparable products.

This strongly suggests that the dataset used to estimate the benchmarking model is contaminated by non-competitive prices. As I understand it, the objective of the ACCC’s benchmarking model is to determine future efficient prices that can be applied to obtain prices on declared routes that are equivalent to the prices that would be negotiated in a competitive market at the time the prices are determined. That is quite a different exercise to determining an overall average relationship. To obtain benchmark efficient prices would involve focusing on low-priced services. In the current exercise this could be achieved by selecting one of the low priced providers (for example, [REDACTED] as the benchmark instead of [REDACTED] or by estimating a frontier model.

For the present exercise, I believe the ACCC could obtain a frontier model by adapting the corrected least squares (COLS) approach to the random coefficient model EI has estimated.

This would be the equivalent of discounting the prices produced by EI's model.³ It would be a regulatory decision to determine the appropriate discount factor that should be applied to the average prices to achieve the ACCC's core objective of promoting competition and efficient investment, not a statistical decision.

As a final point, I believe that Professor Breusch's statement about the average relationship ignores the fact that prices are not static. To ensure that the benchmark prices are still relevant at future points in time when the prices for regulated services need to be determined, account needs to be taken of the fact that prices are decreasing over time. Quite apart from any other considerations, benchmark prices based on a model estimated using prices for services determined three, four, five or six years ago, are not credible approximations to the prices that could be obtained in competitive markets one or two or three years into the future. While the precise rate of price decrease may be in dispute, it is almost certainly not zero, and there is plausible evidence that in the last few years it has been as high as 10% per year. It is hard to see how setting prices at levels of several years ago could be compatible with efficient pricing.

Yours sincerely,



Robert Bartels

³ Given the presence of outliers in the dataset (see p.9 of CEG's report), the COLS approach leads to a more robust frontier than stochastic frontier analysis.

