



Submission in response to

Domestic Transmission Capacity Service Final
Access Determination – Primary Prices

Discussion Paper

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Section 1. Executive Summary

- 1.1 Establishing efficient cost based prices for the Domestic Transmission Capacity Service (DTCS) has proved to be an elusive goal for the ACCC. Whilst the service has been declared since 1997, regulated pricing was only established in 2012. Initially the ACCC left it to the market to set rates through the negotiate/arbitrate regime. An attempt was made to develop cost based pricing but the modelling was never finalised. More recently the ACCC has adopted a domestic market benchmarking approach as the basis to set prices in the 2012 FAD.
- 1.2 The domestic benchmarking approach is a novel approach without international precedent and limited in theoretical justification. This approach was heavily criticised by the industry when the ACCC proposed to adopt it. Regrettably these criticisms have been proven in practice.
- 1.3 Theory indicates that competitive forces, where they exist, are likely to drive prices towards efficient cost. Regulation is applied to non-competitive markets to achieve the efficient price levels that would be likely to arise from competition. In the context of DTCS regulation the rationale for the benchmarking approach is to take price observations from the competitive component of the market and to apply these to the non-competitive component of the market.
- 1.4 However, there is a flaw in the ACCC's approach; competition on the non-regulated DTCS routes is often far from effective:
 - (a) Friction costs exist in the market, such as costs associated with switching suppliers. These limit the effective choice for access seekers, especially for legacy services;
 - (b) Wholesale providers differ in their ability to bundle DTCS with other access services. Telstra, in particular, has a unique ability to bundle regulated and non-regulated DTCS services and to bundle DTCS with any other communication service; and
 - (c) The players with the most bargaining power are absent from the market as they self-supply DTCS in the competitive areas.
- 1.5 The combined impact of the above is that whilst there is some network competition on the non-regulated routes, it is likely to be anchored around the pricing of the dominant carrier. As a consequence there is no guarantee that prices reflect efficient cost of supply.
- 1.6 This issue is compounded by the fact that the ACCC's regression model produces average prices rather than the lowest observed price. In effect, a price premium is added into the FAD to reflect differences in access seekers' bargaining powers. This premium takes the FAD prices a step further away from the efficient cost of supply.
- 1.7 The regression model also incorrectly assumes all types of transmission products are supplied within the same market and have the same level of competition – that is, high capacity inter-capital trunk links have the same characteristics as low capacity lines to business premises. An average price set across different transmission types has had the effect of significantly altering commercial outcomes.

- 1.8 Optus notes that other flaws in the modelling increase the risk of regulatory error. In particular;
- (a) The model is not subject to appropriate peer review arrangements; and
 - (b) Data is excluded without adequate explanations.

Impact of 2012 FAD

- 1.9 The impact of the flaws in the benchmarking approach was clear in the resultant FAD prices issued by the ACCC in 2012:
- (a) At an overall level the FAD only resulted in a modest reduction in charges. The result is that Australia has some of the highest transmission prices in the OECD. For example, the cost of an Australian 2Mbps leased line is around 120% greater than the OECD average;¹
 - (b) However, the FAD prices for some of the most price sensitive routes, such as the short distance lower capacity access tails, was set significantly above existing commercially agreed rates (up to 30-40% higher). This is a clear indication that the FAD prices have no relationship to efficient costs for certain types of transmission services;
 - (c) Access seekers reliant on Telstra access tails faced the untenable prospect of significant downward pressure on retail data prices but with increasing wholesale access prices; and
 - (d) By targeting cost reductions to longer length links, the FAD discriminates against access seekers that have invested in infrastructure. The FAD assumes that there is one market for transmission and fails to adequately take into account differences between high capacity and low capacity links; and long and short distance links.
- 1.10 In practical terms the 2012 FAD has had a disruptive impact on the market and has clearly failed to promote the establishment of efficient pricing and the long-term interests of end-users (LTIE). Since the 2012 FAD, Optus has observed the following:
- (a) The FAD price structure does not align with existing DTCS products, with access seekers incurring additional complexity in rolling over existing agreements.
 - (b) The FAD prices have operated as price floor for commercial negotiations on DTCS, with Telstra seeking to negotiate prices for services outside the FAD price construct at a level above the FAD.
 - (c) Telstra has introduced new product suite (Managed Leased Line or MLL) with a price structure that is incompatible with the FAD price structure. Whilst the service clearly fits within the scope of the DTCS it has been priced on a zonal basis and at levels that represent a significant premium to the FAD.
 - (d) In summary, the FAD has made it more difficult to negotiate DTCS arrangements and has put upward pressure on pricing for the regulated DTCS.
- [CIC]**

¹ See Optus Submission in response to the ACCC's Discussion Paper Domestic Transmission Capacity Service: Public version, 30 August 2013, p.6

Suggested way forward

- 1.11 Optus acknowledges that developing a cost based model will be complex, time consuming and can be subject to significant regulatory error. As indicated in the Discussion Paper, the ACCC has a strong inclination to continue with its benchmarking approach, especially as it anticipates that it will have a broader data set to work with given the increase in the number of competitive routes since the last FAD.
- 1.12 If the benchmarking approach is to be used again, then given its criticisms, it is crucial that:
- (a) Issues raised in this and other submissions by access seekers are properly considered and addressed; and
 - (b) The output of the benchmarking model is not used as the sole source for setting the FAD. It is important for the ACCC to consider other data and evidence in its final pricing decision.
- 1.13 An alternative way forward is to use multiple sources of inputs to inform the efficient DTCS rates. The priority for the new FAD should be to set prices for DTCS services that promote competition in specific markets – a one-size-fits-all approach is not appropriate. In this respect the ACCC should:
- (a) Re-run the benchmarking and regression analysis to inform itself on the trend in prices on the non-regulated services;
 - (b) Obtain data on retail price trends for services where DTCS is an identifiable input. One example is the corporate market, where voice and data services are delivered over DTCS access tails;
 - (c) Obtain general retail price trends for data services;
 - (d) Analyse existing commercial arrangements in the market. An access provider will never sign a deal that is below its own cost to supply (including appropriate returns). Where a commercial deal exists that is lower than the regression output, the ACCC should adopt that commercial price level;
 - (e) Collect actual Telstra internal data on the cost to meet commercial contracts. Every commercial offer put forward by Telstra Wholesale is supported by an internal costing paper that outlines the cost to supply as well as the expected margins from the supply of such services. This data will provide the ACCC with a more realistic sense of the margins between prices and the actual costs of supply;
 - (f) Review international price benchmarks to help determine the normal range in which regulated prices fall; and
 - (g) Develop a cost model in parallel to the benchmarking, based on the fixed line services model, for the regulated DTCS service.
- 1.14 The ACCC should undertake a qualitative assessment based on the multiple inputs above to set DTCS prices that promote the LTIE and competition over specific routes and in specific downstream markets.

Price structure in the FAD

- 1.15 The ACCC should also carefully consider the structure of a new FAD. An issue raised in setting the 2012 FAD was the inconsistency between the ACCC's distance/capacity pricing structure and the price structure of DTCS services offered in the market. Again these risks have played out in practice.
- 1.16 There is a very real risk that the FAD will become irrelevant because:
- (a) Access seekers face significant practical difficulties in moving legacy services to a FAD construct;
 - (b) There is no obligation on access providers to price legacy DTCS services consistently with the FAD; and
 - (c) Telstra has acted on this opportunity to set prices for MLL (which is DTCS under a different pricing construct) at rates well above the FAD, particularly for short distance routes and routes for which Telstra has a clear monopoly. MLL has been offered on a take it or leave it basis.
- 1.17 Optus recommends that a new FAD should be capable of being applied to all Telstra's DTCS product constructs. To keep this simple any percentage change between the 2012 FAD and the 2014 FAD should also be applied to other DTCS products.

Section 2. Observations on 2012 FAD

- 2.1 The preliminary view in the Discussion Paper is that the domestic benchmarking approach will continue to be an appropriate pricing model for the DTCS. However, as discussed in Optus' submissions to previous DTCS Inquiries, these statistical techniques have not been subject to rigorous analysis or appropriate peer review. There has been a lack of transparency over the model's development and use and this has prevented Optus from assessing the robustness of the 2012 regression model. As a result, there is limited ability to comment on its appropriateness as a pricing methodology for DTCS.
- 2.2 Further, it is not reasonable or consistent with the statutory criteria to use the same regression approach unless some key errors have been addressed. Moreover, even if a regression approach could be properly implemented, Optus believes it does not provide sufficient guidance as to what would be efficient pricing. This is because the regression analysis focuses on historic pricing and not costs of supply. No evidence has been presented in the Discussion Paper to make a reasonable conclusion that continuing the 2012 FAD methodology would promote the LTIE.
- 2.3 If the domestic benchmarking methodology is to apply, then it must take into account discounts and other benefits embedded in current commercial negotiations. It should be only one of several inputs used to determine efficient rates.

Reliance on benchmark is flawed

- 2.4 The rationale underpinning the benchmarking approach is that regulation should seek to replicate outcomes of a competitive market. In the case of DTCS, the ACCC has identified routes that are deemed to be competitive because they are supplied by three or more wholesale providers. Competition theory suggests that prices on these routes will be set at an efficient level and, therefore, price observation from these routes can be taken and applied to regulated routes to similarly set those at an efficient level.
- 2.5 However, there are some significant limitations to the theory. Whilst there is competition on the unregulated routes it by no means implies that prices are cost based or should be extrapolated to other services or routes because:
 - (a) Services offered by different wholesale suppliers may not be fully substitutable, with important differences in technology, quality of service, or geographic scope and location.
 - (b) Friction costs exist in the market, such as costs associated with switching suppliers. These limit the effective choice for access seekers, especially for legacy services.
 - (c) Competition for customers often occur through non-price methods, such as free service upgrades or significant rebates and bonuses, meaning that the headline contracted transmission price does not reflect the actual cost paid by end-users.
 - (d) Wholesale providers differ in their ability to bundle DTCS with other access services. Telstra, in particular, has a unique ability to bundle regulated and

non-regulated DTCS services and to bundle DTCS with any other communication service.

- (e) The players with the most bargaining power are absent from the market as they self-supply DTCS in the competitive areas.

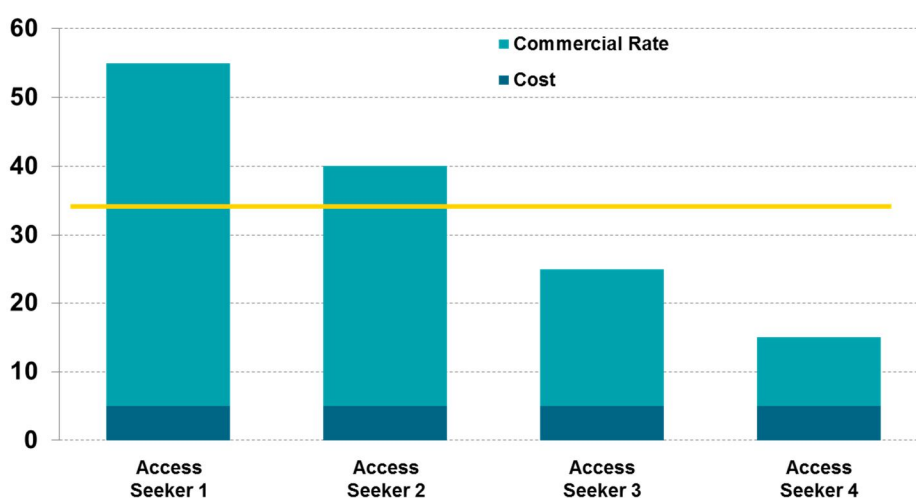
2.6 [CiC]

2.7 The combined impact of the above is likely to result in ineffective competition on the unregulated routes. As a consequence there is no guarantee that prices reflect the efficient cost of supply. Prices are likely to include a substantial mark-up above cost that reflects the relative countervailing buying power of an access seeker.

2.8 The regression analysis compounds the problem by using price averaging to set the FAD prices. In effect a price premium is added into the FAD to reflect differences in access seeker bargaining power. This premium takes the FAD prices a step further away from efficient cost.

2.9 A hypothetical example is shown in figure 1. The access provider faces the same cost to supply services to each of five access seekers. The end commercial price negotiated by the access seekers reflects their relative bargaining power – typically based on the total amount of transmission purchased, as well as an access seeker’s ability to bundle with other wholesale products. Access seeker 1 has the lowest level of buying power and thus pays the largest mark-up over costs, and access seeker 4 has the greater buying power and pays the lowest mark-up.

Figure 1 Setting rates at average monopoly rent level



Source: Optus

2.10 The output of the regression model is a line of best fit through the accepted data observations. In other words, it is the average price of the observed data. This is shown by the yellow line in figure 1. This average doesn’t represent the average cost of provision (which is five in this example), rather it includes the average level of bargaining power of the access provider.

2.11 Setting regulated prices at the average level is not consistent with the objective of regulating prices, nor does it promote competition and the LTIE. Optus repeats that the output of the approach adopted in the 2012 FAD cannot be described as ‘cost-based’, ‘efficient’ or ‘competitive’. Moreover, it is quite possible that the sum of

monopoly rents accruing to the access provider would be higher after regulation than before.

- 2.12 The use of 'competitive' route data to set pricing may also bias the results. Competitive routes are those where the top three to four players have invested. Therefore, it is likely to be the smaller operators who are required to seek wholesale access. In other words, it is the operators that do not have much buying power or which cannot buy in sufficient volumes to get efficient pricing that are setting prices for all markets. Moreover, the input data used in the regression and invoice prices, which does not necessarily reflect the net prices paid by the access seeker due to the use of bonuses and rebates, and the provision of service and quality upgrades without charge. This is a primary flaw in the regression methodology
- 2.13 These conceptual concerns should not be surprising. Optus has been unable to find another regulator that has adopted the 'domestic benchmarking' approach used in the 2012 FAD.

Regression model was flawed in its implementation

- 2.14 In addition to these conceptual flaws, the 2012 FAD 'benchmarking' was implemented in a non-transparent manner and in ways which would be considered inconsistent with basic econometric principles. The analysis seemed to represent a statistical process of estimating the line of best fit, resulting in adjustments to the data which removed much economic meaning from the results.
- 2.15 The analysis used in the current pricing determination is based on a pure, statistical model. As noted in Breusch (2012), "*the draft model does not refer much to the engineering, economic and commercial context of the data, although such considerations do seem to be part of further work being considered by the ACCC.*" It would have been more appropriate to analyse the data using econometric techniques.
- 2.16 The regression methodology undertaken for the 2012 FAD remains questionable. Of particular concern is the reporting of the data used, choice of variables, and how the observations were treated. For a model and subsequent results to be credible it should be replicable. It is understandable that this might not be possible due to commercial confidentiality, but at the very least, some reporting of the data used and a less redacted version of the model should be available for discussion for parties who provided the data in the model.
- 2.17 One central concern of many interested parties was the lack of transparency on the criteria used to reject some data points as outliers, and the extent to which the apparently good fit is due to the trimming the data in this way (i.e. if enough outliers are removed in any given set of observations, a R squared close to the ideal can be achieved).
- 2.18 While trimming of data could make sense for some statistical models, such an approach may not be consistent with econometric modelling – outliers can have important meaning, and thus might have a further significance in the final model. The approach in the 2012 FAD modelling was generally to eliminate these points from the data, often without an appropriate rationale. Such elimination can be subjective and may miss intricacies of the observations. For a more complete analysis, these outliers should be considered with care and ensure that their removal does not have a significant impact on the final regression results.

- 2.19 Outliers are observations which are different, in some sense, from the other observations in the sample. They generally deviate significantly from the normal objects, as if it were generated by a different mechanism. Outliers are interesting because it violates the mechanism that generates the normal data. In practice it could be an indication of market segmentation (particularly in transmission services, for example). Alternatively, they may indicate distinct differences in access seeker bargaining power. It is important to note that, when there is more than one outlier or more than two variables in the analysis, the problem becomes more complex. Removing an outlier also can have large effects on any analysis of the data.
- 2.20 Examination and detection of outliers is a key part of any data analysis:
- (a) Including data that are unusually large or small compared to the rest of the data set run the risk of estimating models that are not representative or that introduce variability.
 - (b) Excluding these values without testing their significance as outliers may seriously bias a model.
- 2.21 The 2012 regression methodology report did not explain in sufficient detail the type of outliers that were identified and excluded. For example, were the excluded data global outliers (if they significantly deviate from the rest of the observations); conditional outliers (if they deviate significantly based on a selected context); or collective outliers (subset of data collectively deviate significantly from the whole data set, even if the individual data objects may not be outliers). Specifically, how many observations were removed; what percentage loss of data they represent; and on what criteria the observations were considered to be outliers – these details and the rationale behind the removal of certain observations, were not explained to access seekers in the 2012 methodology. This limits industry confidence in the predictive power in the 2012 FAD regression methodology.
- 2.22 It would also have been appropriate to analyse the observations that were discarded in the modelling process, as these observations:
- (a) Would have provided further insight into the market and may have produced a more effective price determination; and
 - (b) Might have been unnecessarily excluded, which might explain the goodness of fit of the data.
- 2.23 In summary, Optus recommends that:
- (a) The approach adopted needs to better reflect econometric analysis as opposed to pure statistical analysis;
 - (b) Treatment of outliers needs to be more precise, and any rejection of observations should be based on economic reasons not statistical reasons;
 - (c) Further transparency in the methodology is required; and
 - (d) More industry involvement in data collection and analysis is necessary.
- 2.24 These recommendations should be adopted during the development of the 2014 FAD if the regression approach is to be used again. The Discussion Paper contains no evidence on which one could form a reasonable conclusion that it promoted the

LTIE over the last regulatory period. There is therefore, no evidence that its continued use is likely to promote the LTIE.

The 2012 FAD placed inefficient anchor pricing into the market

2.25 The Discussion Paper seeks information on the extent to which current market observations could be used to inform benchmarking. Optus does not believe that there are sufficient unbiased and independent observations for DTCS types covered by the FAD. As such, it is doubtful whether there are sufficient independent competitive data inputs to ensure a robust analysis.

2.26 Observed prices in the market for services covered by the 2012 DTCS FAD – 2Mbps to 1Gbps – have been impacted by the prices set in the FAD. This also holds for routes where effective competition is present. Some parties may argue that the DTCS FAD only applies as a price ceiling and in the presence of effective competition prices will tend towards the efficient cost based level. Therefore it is legitimate to benchmark prices in routes that are deemed to be effectively competitive. The Discussion Paper notes that:

The ACCC's preliminary view is that domestic benchmarking approach continues to be an appropriate pricing model for the DTCS. This is because there are now a considerable number of domestic transmission routes in Australia that the ACCC has found to be competitive. The ACCC is able to determine prices in these markets as a benchmark for the prices that would apply in regulated areas or routes if they were competitive.²

2.27 Such an observation fails to recognise the impact that the 2012 FAD pricing has had on price negotiations, even in effectively competitive routes. It fails to recognise the impact that anchoring around the regulated price points has on commercial negotiations, and the ability of inefficient anchoring to preclude the discovery of efficient cost-based pricing.

2.28 Anchoring impacts on the efficiency of outcomes because “different starting points yield different estimates, which are biased towards the initial value.”³ Negotiations often start at a suggested starting point (the anchor) and adjustments are made from this point to reach the final outcome. Altering the starting anchor point can significantly alter the final outcome. Research has demonstrated the effect anchoring can have on the outcomes of negotiations. For example, even obviously extreme high starting points leads to higher outcomes.⁴ Anchoring effects are likely to be much stronger in the absence of other information⁵ – this is important to note given the information asymmetry around Telstra’s cost to supply DTCS.

2.29 This is important because benchmarking assumes that the observable pricing represents efficient cost-based pricing. In the context of DTCS, it is assumed that

² ACCC, 2014, DTCS FAD Discussion Paper, p.7

³ Tversky and Kahnman, 1974, ‘Judgement under uncertainty: Heuristics and Biases’, *Science*, New Series, Vol.185, No.4157, pp.1124-31

⁴ For example, starting salary negotiations with an extreme request has been shown to lead to higher final salary outcomes than without the high anchor. Thorsteinson, T. J., 2012, ‘Initiating Salary Discussions With an Extreme Request: Anchoring Effects on Initial Salary Offers’, *Journal of Applied Social Psychology*, Vol.41(7), pp.1774-92. Similarly, research shows that parties making the first offer in negotiations obtained a better outcome. See, Galinsky and Mussweiler, 2001, ‘First offers as anchors: the role of perspective-taking and negotiator focus’, *Journal of Personality and Social Psychology*, Vol.81(4), pp.657-69.

⁵ Kahneman, D, 1992, ‘Reference points, anchors, norms, and mixed feelings’, *Organisational Behaviour and Human Decision Processes*, Vol.51, pp.296-312

the rates seen in the market represent the cost to provide the service plus some mark-up for common costs and an appropriate level of return on the investment. This implies negotiations occur around the cost to provide the service. As discussed earlier in this section, this is not the case for DTCS.

- 2.30 Previously, discounts could be secured in commercial negotiations even on non-competitive routes because of the threat of regulation. However, this does not mean that prices were cost based. Since the 2012 FAD negotiations have been anchored around the FAD prices and discounts have generally not been available.
- 2.31 Part of the problem relates to the structure of the FAD prices which does not align with services purchased by access seekers. This has given Telstra the opportunity to leverage rates above the FAD. This issue can clearly be seen in the development of Telstra's MLL product suite. The impact of the 'new' pricing was to set the access price at or above the relevant regulated rate.
- 2.32 Telstra's pricing applies to both regulated and non-regulated routes. While commercial negotiations around the MLL price points may be possible, the negotiations are anchored at that starting point which is at or above the regulated rate. There is no reference to the cost of the service, or to the level of appropriate return accruing to Telstra. It is simply the dominant player putting anchor pricing in the market that reflects the regulated rate.
- 2.33 [CiC]

Figure 2 Average Transmission Pricing 2Mbps

[CiC]

Source: Optus analysis

- 2.34 [CiC]
- 2.35 [CiC]
- 2.36 Optus does not see how any new regression can overcome the large gap between 'new' commercial prices and the 2012 FAD prices. For instance, a regression on 'competitive' routes might show that prices are on average 10% below the previous regulated rates – in other words, Telstra may offer a 10% discount on its product suite for competitive routes. If this discount was applied to the existing FAD prices then it would provide no benefit to users of MLL services. Even if the MLL services were discounted by 10%, the rates would still be well in excess of the existing FAD prices [CiC].

Did the 2012 FAD promote the LTIE?

- 2.37 The ACCC must set terms and conditions within a FAD that are consistent with the legislative criteria. Optus submits that it is reasonable that an assessment of the outcomes of the 2012 FAD should be used to inform the assessment as to the likely consistency of the new FAD; especially where it is proposed to continue with the same approach.

- 2.38 The legislation requires that when making an access determination, the ACCC must take the following matters into account:⁶
- (a) Whether it will promote the long term interest of end-users;
 - (b) The legitimate business interest of access providers and the access provider's investment in facilities used to supply the service;
 - (c) Interests of all persons who have a right to use the declared service;
 - (d) The economically efficient operation of a service, network or facility;
 - (e) Value of extensions and the operational and technical requirements necessary for the same of reliable operation of a service, network or facility.
- 2.39 When considering whether something promotes the LTIE, regard must be had to the following objectives:⁷
- (a) Promoting competition in relevant markets;
 - (b) Achieving any-to-any connectivity;
 - (c) Encouraging the efficient use of, and the economically efficient investment in, infrastructure by which services are supplied, including:
 - (i) the legitimate commercial interests of the access provider;
 - (ii) incentives for investment.
- 2.40 The primary objective of access regulation is to promote competition. This is concerned with enabling efficient suppliers to operate in dependent markets, to gain the benefits of the process of competition such as lower prices for consumers and displacement of inefficient suppliers by efficient suppliers.⁸ One reason for the primacy of the promotion of competition is that it enhances economic efficiency and consumer welfare – in simple terms competition is the force that leads to efficiency and monopoly is condemned for distorting it.⁹
- 2.41 Another key element is the efficient use of, and investment in, infrastructure used in the provision of declared services. Access providers will have an incentive to make efficient investments so long as it receives a normal return on the investment.¹⁰ This requires that a carrier can recover the costs of its infrastructure, its operating costs and obtain a normal return on its capital.¹¹
- 2.42 It is clear that the common elements across the main matters to be considered are the promotion of economically efficient outcomes – both usage and investment. One could argue that if a FAD promoted economically efficient outcomes then it promotes the LTIE and other matters. Much discussion has occurred on what is efficiency in the context of Part XIC.

⁶ Section 152BCA

⁷ Section 152AB

⁸ Re Telstra Corporation Ltd (No 3) [2007] ACompT 3 (17 May 2007), [98-9]

⁹ Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009), [1]

¹⁰ Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [103]

¹¹ Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [104]

- 2.43 The Competition Tribunal has commented that productive and allocative efficiency related to “*the most efficient use of the resources and technology currently available to a firm, in **any given time period.***”¹² [emphasis added] Further, allocative efficiency will be “*best promoted where the price of a service reflects the underlying marginal cost of providing the service.*”¹³
- 2.44 Dynamic efficiency is a concept that involves consideration of adaptation by firms to the evolving supply and demand forces in the market.¹⁴ It involves two elements:
- (a) Preserving incentives for innovation and investment;¹⁵ and
 - (b) Ensuring ongoing competition which forces firms to seek to improve their goods or develop new goods as part of the battle.¹⁶
- 2.45 Dynamic efficiency takes into account investment decisions by the access provider, now and in the future. This requires that regulated prices be set at levels allowing recovery of efficient investments (irrespective of whether they are sunk). Specifically, dynamic efficiency takes into account the trade-off between short term and middle (or long) term dimensions in order to guarantee adequate returns to an investment.
- 2.46 Dynamic efficiency also looks at competitive entry and the additional competitive pressure to reduce costs over time. This takes into account the chilling effect on competitive investment as a result of high access prices leading to less-than-optimal levels of independent infrastructure investment.¹⁷ Higher access prices would promote further investment by access providers, but may also discourage competitive investment by access seekers.

Promoting competition

- 2.47 Competition is promoted where prices are set at the efficient level, and firms are able to compete on the basis of their relative efficiencies, product innovations, and customer service rather than based on benefits of regulatory decisions.
- 2.48 The first step when assessing the extent to which competition in related markets is promoted is to identify the relevant downstream market. Optus has submitted several times that the ACCC has failed to adequately identify all the related markets and has failed to undertake a reasonable assessment of the competitive impacts of its pricing decisions on DTCS.
- 2.49 Optus agrees with the observation that declaration of DTCS “*promotes competition in downstream markets*”.¹⁸ The ACCC has previously defined the relevant downstream markets as the “*range of wholesale and retail services that can be supplied using transmission services*”.¹⁹ While this observation is correct, it is incorrect to say that all types of DTCS impact all markets equally. It is not reasonable to assume that if DTCS prices fall on average than competition in related downstream markets increase. The ACCC has failed to identify whether there are

¹² Re Qantas Airways Ltd [2004] ACompT 9 (12 Oct 2004), [160]

¹³ Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [94]

¹⁴ Re Qantas Airways Ltd [2004] ACompT 9 (12 Oct 2004), [159]

¹⁵ Re Duke Eastern Pipeline Pty Ltd [2001] ACompT 2 (4 May 2001), [63]

¹⁶ Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009), [33]

¹⁷ Application by Telstra Corp Ltd [2009] ACompT 1 (22 May 2009), [156]

¹⁸ ACCC, 2013, DTCS Declaration Final Report, p.19

¹⁹ ACCC, 2013, DTCS Declaration Final Report, p.25

certain markets that are impacted by specific types of DTCS services, and has failed to assess how the price changes impact competition in these markets. Optus submits that if these factors are given proper weight the decision to continue with the 2012 FAD method could not have reasonably been formed.

- 2.50 Optus has previously informed the ACCC that the impact of the 2012 FAD pricing was: **[CiC]**
- 2.51 By setting access prices significantly greater than the cost to provide for specific types of links, the ACCC has favoured operators that have not invested. The incentive to invest in competitive transmission equipment to get closer to end-users has been reduced. It does not appear that the Discussion Paper has given sufficient weight to these impacts – indeed no reference is made to these issues.
- 2.52 Optus submits that the 2012 FAD has failed to promote competition in:
- (a) Downstream related telecommunications markets as the prices set are significantly greater than the efficient cost incurred by access providers. This has resulted in a significant cost advantage for the dominant operator who can self-supply DTCS services at a level far below that available to other operators.
 - (b) Specific markets, such as the corporate and government market, have been impacted by the significant price increase observed for specific DTCS types. The 2012 FAD set prices for access network tails at levels well above existing commercial prices. This has made it impossible for access seekers to achieve discounts on this wholesale input cost even though retail prices for services offered over those access tails has been subject to intense price discounting.
 - (c) The FAD also price discriminates against access seekers by favouring those which have made little investment in infrastructure.
- 2.53 On the available information, a conclusion cannot be reasonably formed that the 2012 FAD promoted competition in related downstream markets. Optus repeats its concern that no assessment has been made of the impact on competition prior to the recommendation to continue with the 2012 FAD approach. No evidence has been presented that demonstrates competition has improved prior to the decision to continue with the 2012 FAD approach. It is therefore not reasonable to form a conclusion that competition will be promoted if the current approach is continued.

Economic efficiency

- 2.54 Economic efficiency requires an assessment of allocative and dynamic factors. Allocative efficiency will be "*best promoted where the price of a service reflects the underlying marginal cost of providing the service.*"²⁰ Dynamic efficiency is promoted by preserving incentives for innovation and investment²¹ and ensuring ongoing competition.²²
- 2.55 The prices set in the 2012 FAD do not represent the underlying marginal cost of providing the service. This is clearly shown by the comparison of commercially negotiated rates for specific route types and the 2012 FAD prices (see paragraph 2.33). Access seekers face prices significantly greater than the cost incurred by the access provider to supply certain transmission services. Access seekers, therefore

²⁰ Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [94]

²¹ Re Duke Eastern Pipeline Pty Ltd [2001] ACompT 2 (4 May 2001), [63]

²² Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009), [33]

face higher marginal costs to provide services in related downstream markets than faced by the dominant provider. This is particular acute for markets that rely upon low capacity low distance links.

- 2.56 The 2012 FAD has damaged the incentive to invest in competitive transmission equipment for specific types of routes. For example, almost *all* access seekers commented in the 2012 FAD process that prices for 2Mbps links below 30km distances were significantly higher than current commercial rates.²³ The ACCC did not directly respond to these observations, other than to state it has the ability to make BROCs if needed.²⁴ Recent OECD data supports the position of Access Seekers: only Japan and Slovak Republic have higher costs for 2Mbps leased line than Australia. The cost of an Australian 2Mbps leased line is around 2.2 times greater than the OECD average.²⁵
- 2.57 On the available information, a conclusion cannot be reasonably formed that the 2012 FAD promoted efficient use of, or investment, in transmission equipment. It provides a cross-subsidy away from short distance to long distance links; favouring operators that do not invest in transmission equipment. Moreover, the dominant provider of transmission services, which is also the dominant provider in *all* related downstream markets, faces a significantly lower marginal cost to self-supply transmission services than faced by access seekers.
- 2.58 Optus reiterates that the Discussion Paper fails to take into account relevant factors including whether the 2012 FAD was consistent with the statutory criteria. It is not reasonable to continue with the same approach if it cannot be shown that this approach promoted the LTIE during the last regulatory period.

²³ Optus, AAPT, Macquarie Telecom, Primus and VHA.

²⁴ ACCC, Final Access Determination for the Domestic Transmission Capacity Service, Explanatory Statement June 2012, pp.14-5.

²⁵ See Optus Submission in response to the ACCC's Discussion Paper Domestic Transmission Capacity Service: Public version, 30 August 2013, p.6

Section 3. Pricing methodology for new FAD

- 3.1 The ACCC has a preliminary view that the domestic benchmarking approach will continue to be an appropriate pricing model for the DTCS. However, it is shown in section 2 that the domestic benchmarking approach adopted in the 2012 FAD has not promoted the LTIE, competition, or the efficient investment in, and use of, transmission equipment. Optus remains concerned that these factors have not appeared to be taken into account by the ACCC when proposing to continue with the same method.
- 3.2 After several attempts at setting efficient DTCS rates through relying on the use of different single methodologies, Optus sees merits in the use of several different methods to inform the ACCC about the efficient cost of DTCS. No single method is perfect; each of the previous methods has proven to be unhelpful in its own special way. The new FAD should manage the risk of regulatory error more effectively than previous FADs.

Multiple input approach is now warranted

- 3.3 Section 2 demonstrates that reliance on one method, the domestic benchmarking approach, was not an efficient and appropriate methodology for setting regulated DTCS prices. In particular, the pricing of DTCS has not sufficiently focused on promoting competition in all related downstream markets, and has failed to adequately promote the LTIE. For instance, the ACCC's pricing approach distorts the build-buy decision by favouring access seekers that buy access to rather than build transmission links. No evidence has been presented in the Discussion Paper that the domestic benchmarking method resulted in outcomes that are consistent with the legislative criteria.
- 3.4 DTCS is a complex system. While it is appropriate to declare the service to prevent exploitation of monopoly rent by the incumbent, it is not necessarily appropriate to have a one-size-fit-all approach to price the service. Pricing each segment of the service separately under an appropriate pricing principal, rather than adopting a uniform approach, may be more appropriate for DTCS.
- 3.5 Relying on one input significantly increases the risk of regulatory error. As indicated in section 2, the 2012 FAD has been ineffective and has resulted in upward price pressure for services provided on regulated routes.
- 3.6 The priority for the new FAD should be to set prices for DTCS services that promote competition in specific markets. Optus recommends that the ACCC use multiple inputs to inform itself of the appropriate rates for DTCS. In this respect the ACCC should:
 - (a) Produce rigorous econometric regression analysis to inform itself on the trend in prices on the non-regulated services.
 - (b) Obtain data on retail price trends for services where DTCS is an identifiable input. An example is the corporate market where voice and data services are delivered over DTCS access tails.
 - (c) Obtain data on general retail price trends for data services.

- (d) Analyse existing commercial arrangements in the market. An access provider will never sign a deal that is below its own cost to supply (including appropriate return). Where a commercial deal exists that is lower than regression output, the ACCC should adopt the commercial level.
 - (e) Collect actual Telstra internal data on the cost to meet commercial contracts. Every commercial offer put forward by Telstra Wholesale is supported by an internal costing paper that outlines the cost to supply as well as the profits made. The ACCC should utilise actual data to assess the cost of the service. Regulated rates could then be based on the actual cost to supply.
 - (f) Review international price benchmarks to help determine the normal range in which regulated prices fall.
 - (g) Develop a cost model for DTCS, possibly extending the fixed line model to incorporate DTCS.
- 3.7 The ACCC should utilise these steps and take a qualitative assessment to set DTCS prices that promote the LTIE for specific routes and that promotes competition in specific downstream markets. Optus comments on a number of these specific points further below.

Internal cost data on regulated DTCS pricing

- 3.8 It should be possible for the ACCC to collect information from Telstra on the cost incurred to provide specific regulated transmission links. When new contracts are signed or existing contracts rolled over it is likely that Telstra will prepare detailed business costings to support the proposition being offered.
- 3.9 Optus sees merit in the ACCC acquiring this information to inform itself about the direct cost of providing DTCS services. **[CiC]**
- 3.10 Optus reiterates that no access provider supplies DTCS services at a price below its cost to supply. Where evidence exists that a commercial deal has been agreed to below the regulated rate, the new FAD should adopt the lowest commercial price as the new regulated rate.

Retail market trends

- 3.11 Optus also supports the use of indirect observations to fully understand the trends in underlying cost to provide.
- 3.12 It appears reasonable that trends in related retail markets would be broadly consistent in the cost trend of wholesale inputs. For instance, if the retail price of data per MB was decreasing by 10% per annum, it would be reasonable to expect that this is at least partly driven by falls in the cost to provide wholesale data transmission (domestic and international).
- 3.13 Further, the ACCC should benchmark prices for services that rely more directly on DTCS as an input. An example is the voice and data services supplied over DTCS access tails for corporate end-users. The ACCC should seek trends in retail prices for these services. Such data would provide a sanity check on the outputs of the ACCC's modelling. If this had been used in the 2012 FAD, it could have allowed the ACCC to better refine its pricing and avoid a situation where the regulated wholesale rates

for access tails increased in the face of declining retail prices for services offered over those access tails.

3.14 [CiC]

Consideration of international methods

- 3.15 Optus suggests that the ACCC investigate the manner in which regulated transmission prices are set for DTCS-equivalent service internationally such as in the European Union ("Market 6"). Market 6 (Wholesale Leased Lines) refers to an EU-wide market comprising wholesale terminating segments of leased lines, *irrespective of the technology used to provide leased or dedicated capacity*. National Regulatory Authority (NRA) in individual country generally follows cost orientation in regulation of Market 6.²⁶ In most EU markets, Market 6 generally applies to terminating links, as most trunk routes have been deemed to be competitive.
- 3.16 In the UK, Ofcom uses RPI-X price control and implemented on two separate service baskets for wholesale services:
- (a) Traditional interface – covering low, medium and high bandwidth services outside the WECLA, low bandwidth services within the WECLA and regional trunk services at all bandwidths.
 - (b) Ethernet – covering services up to and including 1Gbit/s outside the WECLA and Ethernet services above 1Gbit/s outside the WECLA.
- 3.17 Ofcom applies different price controls for the TI basket and Ethernet basket; RPI+2.25% and RPI-11.50% respectively.²⁷ Rather than applying a one-size-fits-all approach, Ofcom had re-adjusted their price control measures based on the nature of the service, the changes experienced in the market, and other macroeconomic factors. Optus sees merit in adopting a more disaggregated approach to DTCS pricing in Australia.
- 3.18 In Malta, the regulator (MCA) mandated new prices for wholesale local leased lines and Ethernet connections respectively. The prices utilised the new Bottom-Up Cost Model for Fixed Networks, which has been developed by the MCA with the objective of calculating efficient cost oriented prices for various wholesale regulated services including leased lines and Ethernet connections.
- 3.19 Importantly, the charging model distinguishes clearly between the wholesale local leased lines and Ethernet connections, with a decrease in prices for Ethernet from 2013. Optus notes that this is consistent with lower charges for transmission services over time as a higher proportion of Ethernet uptake occurs over time. Optus submits that the LTIE would be promoted by separating price controls for non-Ethernet and Ethernet connections, to ensure access seekers are given a low regulated rate for their service, rather than an average price that is skewed towards the higher-priced, non-Ethernet connections.

²⁶ Cost orientation is an ex ante price control based on costs of efficient service provision (LRIC) and is the price control method used by more than 60 per cent of NRAs in 2012. Specifically, countries in the EU that follows cost orientation include Belgium, Germany, Denmark (Copper <2Mbps only), Estonia (Copper only, retail-minus for Ethernet), France (10Mbps and below), Ireland, Italy (price cap and less strict on higher capacities >155Mbps), Netherlands, Poland, Portugal, Sweden and the UK.

²⁷ <http://stakeholders.ofcom.org.uk/consultations/business-connectivity-mr/final-statement/>

Modelling of transmission costs

- 3.20 In parallel to benchmarking the ACCC should develop a cost model for the regulated DTCS. Such an approach will recognise that:
- (a) Transmission is provided over existing sunk infrastructure; and
 - (b) That any additional costs associated with establishing a service a fully recovered through connection charges and/or Special Linkage Charges. These charges will cover the costs of any new electronic equipment and the costs of extending an existing transmission link.
- 3.21 Similar to the approach the ACCC has taken with MTAS, such a DTCS cost model would form one input to the process of setting regulated prices for DTCS. Optus acknowledges the difficulty in developing a stand-alone DTCS model; however, it is reasonable to expect that costs to supply transmission equipment can be derived from the data supplied by Telstra during the fixed-line services FAD.
- 3.22 For example, based on information provided in Telstra's Cost Allocation Framework,²⁸ there is sufficient information with respect to allocation of costs for transmission equipment (Telstra's SDH and PDH transmission network). For example, there is information to "*calculate cost allocators for the relevant regulated fixed line wholesale services with respect to CO05*" (Transmission Equipment).²⁹ If Telstra is able to do this accurately, then it is able to determine the length of fibre used to deliver transmission services (internally and externally) and its associated cost.

²⁸ Telstra, 2014, Cost Allocation Framework for the ACCC Fixed Line Services Model Framework and Model Guide - Version 1 - July 2014 - Public Version

²⁹ Telstra, 2014, Cost Allocation Framework for the ACCC Fixed Line Services Model Framework and Model Guide - Version 1 - July 2014 - Public Version, p. 41

Section 4. Other issues

Alternative methodologies

Regarding a methodology identified in question 2, how would it be applied (for example, with a fully allocated cost model) how would costs be allocated (including cost sharing factors) given transmission network characteristics?

Regarding a methodology identified in question 2, what are the likely resourcing requirements needed to give effect to it?

Regarding a methodology identified in question 2, what are the information requirements needed to undertake a robust analysis?

Regarding a methodology identified in question 2, what are the likely methodology costs?

Regarding a methodology identified in question 2, explain how that approach is likely to provide a materially better outcome to the benchmarking approach.

- 4.1 Optus addresses these questions in section 3. Optus supports the use of multiple methods to inform the ACCC the range in which efficient costs lie. Relying on one method results in too high a risk of regulatory error. This has been clearly demonstrated by reliance on the untested regression method adopted in the 2012 FAD. With regards to whether Optus' recommendation is likely to provide a materially better outcome, we refer to section 2 which shows that no evidence has been supplied to demonstrate that the benchmarking approach was consistent with the legislative criteria. It is not reasonable to recommend the same approach absent such evidence.
- 4.2 Optus further notes that the regression method is likely to be the highest cost option, and also the least likely to estimate rates that promote the LTIE. The ACCC should also rely on the existing FLSM and appropriate cost allocations, international benchmarking, and qualitative analysis on observed pricing practices and trends in the market.

Stakeholder engagement

What level of engagement by industry or independent experts would be necessary/appropriate for analysis of the pricing data in establishing the regression model for benchmarking DTCS prices?

What specific confidentiality safeguards are required to ensure that relevant experts have appropriate access to raw pricing data to assist the ACCC?

- 4.3 Relevant stakeholders should be provided with sufficient level of materials to enable them to provide appropriate analysis of the pricing principles. Basic econometric principles require that any analysis be replicable. Absent access to data this cannot be achieved. This can be achieved under appropriate Confidentiality Agreements that should be centrally established by the ACCC.
- 4.4 Moreover, the ACCC should take more regard to the views of stakeholders. Optus notes that almost all stakeholders have raised criticisms of the regression approach,

and yet the ACCC maintains that this approach is appropriate. This is not a reasonable position to take.

- 4.5 It was evident from the last Declaration period that the process lacked transparency and therefore access seekers were unable to provide informed discussion in relation to the pricing principles. The data set used for any analysis must be made available for independent analysis by interested parties. Optus views on this are further outlined in section 2.

Regression model

What changes to the 2012 DTCS FAD regression model should the ACCC consider in building the 2014 regression model to calculate benchmark prices for the 2015 DTCS FAD?

- 4.6 Optus strongly opposes the use of the 2012 regression model to set prices in this FAD. There are substantial methodological and implementation problems with the 2012 model. See section 2. No evidence has been supplied to demonstrate that the benchmarking approach was consistent with the legislative criteria. It is not reasonable to recommend the same approach absent such evidence.
- 4.7 It may be possible to implement a regression model. But this assumes that appropriate inputs are identified, the form of the regression is reasonable and the variables are all correctly defined. Outliers must not be removed from the analysis without appropriate economic reasons to do so.
- 4.8 As discussed in section 3, with appropriate changes a regression model should be used as one input to inform the ACCC as to the rates that best promote the LTIE. The ACCC must not solely rely on the outputs of the model.

Should the ACCC focus on prices negotiated since the 2012 DTCS FAD in establishing pricing benchmarks or should the ACCC only focus on prices negotiated in 2014?

- 4.9 Optus discusses this issue in section 2. In summary, the flawed 2012 FAD prices set inefficient anchors in the market for DTCS prices in the FAD. This impacted both regulated and de-regulated routes. Optus queries whether there are sufficient independent observations in the market to produce a legitimate regression analysis. This is particularly the case for the MLL suite of products, including short distance low capacity links.

Should the ACCC reconsider the approach to selecting the benchmarked price point to use to set regulated prices? If so, which approach would be more appropriate and why?

- 4.10 The ACCC should reconsider the use of an average DTCS price using domestic benchmarking. As discussed in section 2, setting average prices is not consistent with the legislative criteria. There is no guarantee that prices are reflective of costs, and as such the ACCC cannot be reasonably satisfied that an average price control promotes competition or economically efficient use of and investment in infrastructure.
- 4.11 An important issue for the ACCC is to identify the latest negotiated rates. These will largely be driven by the bargaining power of parties and not necessarily the timing of negotiations. It would be inconsistent with the LTIE if the FAD were to set average prices in excess of existing commercial deals.
- 4.12 Moreover, adopting an average price point across all DTCS types and technologies is unlikely to promote the LTIE. Market evidence, in Australia and internationally,

demonstrates that Ethernet transmission is priced at levels below legacy technology. Optus notes the position in the EU markets which set different cost controls on the different technologies. There is merit in adopting a similar approach in Australia.

- 4.13 The ACCC should not adopt the 'mean value' to set prices. As discussed earlier this is likely to inflate actual market prices. As an alternative, the ACCC should choose an approach which draws from the lowest price observation.

Is an approach that accounted for expected changes in price over time (that is, based on analysis of pricing data from 2012 to 2014 and projected forward into the next FAD period) appropriate for the next FAD?

Alternatively, should the ACCC consider periodic re-pricing during the next FAD? If so, why? How frequently should the ACCC consider re-pricing and should it be automatic or a full review?

- 4.14 Taking price trends from one period to the next and applying a discount based on this has some merit, but it will not address the inherent issues with the structure of the FAD that Optus has discussed in section 2. To address the structural concerns it will be important for the discount based on price trends to also apply to the services access seekers purchase (such as X162/3 and MLL services). Also, as indicated in section 3, the outputs from any model should be checked against commercially agreed rates.

Should the pricing of services over the SDH interface be considered separately from Ethernet services?

- 4.15 The adoption of a technology-neutral DTCS Declaration does not necessarily mean that the FAD must set one price covering all technologies. The relevant criteria are whether one approach better promotes the LTIE. There should be no pre-determined bias for technology-neutral pricing.
- 4.16 Optus notes that commercial prices differ depending on the technology adopted. See for example, the different prices across Telstra Wholesale's MLL suite – including for Ethernet, SDH, etc.
- 4.17 Optus also notes that other regulators have set different prices for different technologies. For example, Ofcom separated the wholesale markets into: Traditional interface symmetric broadband – relates to SDH and PDH; Alternative interface symmetric broadband – relates to Ethernet; and Multiple interface symmetric broadband – relates to WDM products.
- 4.18 The ACCC should consider doing similar categorisation to improve the pricing principles. Any regression equation should analyse the data to see whether there are structural breaks for the different technologies. Optus repeats that the 2012 FAD has demonstrated a one-size-fits-all approach is not consistent with the legislative criteria.

Should the ACCC maintain the approach to incorporate a variable for 'protection' in the regression model?

- 4.19 Optus supports the retention of protection in the pricing of DTCS. This is consistent with existing commercial practices. The pricing of protection, however, must reflect actual protection used in commercial products. For instance, tail-ends are generally

unprotected. Thus, bundles that have a tail-end included could have protected sections and unprotected sections. Any regulated pricing should reflect this.

What is the minimum form of protection required for a DTCS service?

- 4.20 Ideally, as a minimum, protection should be geographically diverse in the core network. Moreover, carrier grade Ethernet backhaul service requires geographic diverse protection because Ethernet services are designed to be rerouted.
- 4.21 Optus considers that access seekers should be given the option to choose between protected and non-protected routes. The FAD pricing should also include a discounted price for a service without redundancy. Therefore any pricing of transmission services should not be burdened with the costs of a protected service, particularly given that protected services are not always warranted. Protection should be optimal.
- 4.22 It follows that the pricing of transmission services should not as a general rule reflect the costs of a protected service since this would not promote competition or encourage the efficient use of infrastructure. Rather this would lead to an over-recovery of costs along certain routes, which distorts efficiency by discouraging the efficient use (utilisation) of the infrastructure.

Is quality of service sufficiently reflected in the 2012 DTCS FAD regression model?

- 4.23 The development of the 2012 FAD included a 'Quality of Service' (QoS) model, which utilised a term for the QoS, route category, data rate, distance, protection and various interaction terms but had a slightly less accurate fit than the alternative model. This was later used to determine pricing terms for transmission.
- 4.24 While it may have been appropriate on a statistical basis to exclude QoS variable, it is not clear whether there were legitimate econometric reasons. If the variation in the closeness of fit was not significant, there may be merits in maintaining the QoS variable. This should be re-examined in any new analysis. The ACCC should not take a pre-determined approach into any regression analysis. Should the ACCC re-do a regression analysis it must be consistent with econometric principles and commercial reality.
- 4.25 Competition in the market is trending towards non-price factors such as higher levels of quality and greater SLAs. For instance, a provider may offer the same link for the same price to multiple resellers and other wholesale customers. But it may require resellers to pay for certain levels of quality, whereas it could offer greater levels of quality free of charge to certain wholesale customers. **[CIC]**

Are the route categories of inter-capital, metropolitan and regional relevant for the next FAD?

- 4.26 The current DTCS FAD pricing distinguishes between the following elements;
 - (a) Inter-capital routes;
 - (b) Regional routes;
 - (c) Metropolitan routes; and
 - (d) Tail-end services, a route wholly with a single ESA.

- 4.27 However, all of these services are regulated in the same manner, and subject to the same benchmarking analysis. It implicitly assumes that the services are equally in demand by Access Seekers, and impact the same downstream related markets in the same manner. It also assumes that end-users that suffer higher prices for services using one DTCS service also face lower prices for services that utilise other DTCS services – thereby being unaffected on a net basis.
- 4.28 Optus submits that the pricing of the transmission elements should better reflect the requirements of access seekers. On a commercial level, the pricing of inter-capital routes in no way impacts the pricing of local tail-end products. Carrier Grade Ethernet is not a service that can be used to provide low capacity links for business users. The new FAD should price these services differently, and use different methodologies where appropriate.

Should the ACCC consider adopting a route type matrix approach for pricing in the next FAD?

Are there any alternative approaches to the existing route categories or Telstra route type matrix that balance transparency and simplicity with a higher level of cost reflectivity?

Should the ACCC consider using a route type matrix in deriving DTCS pricing from the regression model?

- 4.29 The methodology used should be applicable to every service regardless of how the incumbent structures its prices. The route-type matrix is currently used as the default pricing construct in commercial negotiations. Optus believe the ACCC should focus on pricing DTCS closer to actual cost of supplying DTCS rather than considering a new methodology in their regression methodology.
- 4.30 The current FAD approach is redundant in current commercial negotiations. It offers little assistance and does not result in lower commercial rates. The prices in the new FAD should be set in a manner which enables it to be applied to all price structures and services purchased.

Should the ACCC continue with its approach to the distance variable in the regression analysis?

- 4.31 The ACCC should not take a pre-determined approach into any regression analysis. Should the ACCC re-do a regression analysis it must do so independently consistent with econometric principles and commercial reality. There may be some DTCS types (such as carrier grade transmission or BTS backhaul) where distance is an appropriate variable; and there are others where it may not be (such as tail-ends and other low capacity metro links).

What range of capacities should the ACCC price?

- 4.32 Optus submits that the ACCC should set prices for the capacities that are commonly available for transmission services. This will include the 2Mbps to the higher order capacities up to 10Gbps services. This is in line with the ACCC's expectation of an increased level of subscriptions for higher capacity services in the transmission market.
- 4.33 The ACCC also noted in the discussion paper that 2Mbps services are reducing as a proportion of total contracts entered into for DTCS services. **[CiC]**

Should the range of capacities for which the FAD prices apply be reviewed during the term of the next FAD?

- 4.34 Optus submits that the FAD should be subjected to a review every 12 months. Previous pricing approaches have resulted in significant regulatory error, as a result constant review will help the ACCC to refine its approach and better manage regulatory error.

Demand

Should the regression analysis consider the level of demand (reflected by some measure such as a combination of population density and services in operation) as a variable in the analysis?

- 4.35 This will depend on the length of the FAD. The ACCC should not take a pre-determined approach into any regression analysis. Should the ACCC repeat its regression analysis, it must do so independently and be consistent with econometric principles and commercial reality.

Contract length and terms

To what extent should the regression analysis focus on contract length?

Should the ACCC continue to price the DTCS for a contract period of 12 months in the next FAD? If not, what term period should be considered and what are the costs and benefits of an alternative approach?

- 4.36 Contract length plays an important role in the pricing of transmission services. Discounts are often offered for longer term contracts. However, it is important to recognise that the discounts offered for different contract terms do not reflect the costs of supply; rather they reflect differences in the bargaining power of the access provider and access seeker. Discounts for term must be fully reflected in the modelling.
- 4.37 Price will be cheaper the longer term the contract. **[CiC]** This means that longer contract prices would sit closer to the marginal cost of supply DTCS. The ACCC should use the prices for longer contracts in any regression analysis, as well as discount shorter term contracts to better reflect the cost of supply the service.
- 4.38 It is also important to note that the data used in the regression are invoice data, and not the actual price of the service. This is a clear indication that the regression will be once again a flawed analysis if invoice data continued to be used in the next pricing determination.
- 4.39 This highlights a wider issue around the use of invoice prices. As noted above, competition is trending towards non-price factors – that is, getting more services and high quality for the same invoice price. Further, off-invoice factors such as bundle, discounts, sign-on and retention bonuses or discounts should also be considered.

Discounts

How should the ACCC take into consideration the effect of term and/or whole-of-business discounts in setting DTCS prices in the next FAD?

Which of the discounts, which are made available as part of commercial negotiations, should be taken into account in the regression analysis?

- 4.40 There is a wide range of discounts currently being offered as part of commercial negotiations. **[CiC]**
- 4.41 Discounts are applied to reduce final prices below the level of the standard list price. Optus considers that it would be appropriate to take into account the full range of discounts offered and include the discounted prices in the model within the regression analysis.
- 4.42 As indicated above, discounts are not driven by the costs of supply; they more usually reflect differences in bargaining power. As a result Optus suggests that the ACCC obtain corporate pricing approvals from access seekers to obtain a better data set in the regression analysis.
- 4.43 FAD prices should reflect the current commercial practise to give discounts for longer contract periods, for example, a 50% discount on connection charges for a 2 year lease and a 100% discount on connection charges for a 3 year lease.
- 4.44 Contract length and level of protection both play an important role in the pricing of transmission services and should be included in the regression model.
- 4.45 Access providers usually offer discounts on monthly recurring charges for longer contract terms. For example, **[CiC]** Similarly, the level of protection considered will also influence the final transmission price – that is, an unprotected service will usually be lower cost than a protected service.
- 4.46 This highlights a wider issue around the use of invoice prices. As noted above, competition is trending towards non-price factors – that is, getting more services and high quality for the same invoice price. Further, off-invoice factors such as bundle, discounts, sign-on and retention bonuses or discounts should also be considered. Optus also understands that competition for customers is focused on the overall value of products and not just at the cost of DTCS inputs. Large customers purchase a range of service and their decision is based on whole-of-business value.
- 4.47 These commercial realities make it difficult to rely solely on the outputs of a regression analysis, irrespective of how well implemented. Optus supports the use of multiple inputs when setting the DTCS rates.

Tail-end services

Should the pricing of tail-end services as a stand-alone product be revised to reflect the market practice of bundling?

- 4.48 The ACCC's proposed method cannot readily be applied to pricing tail-end DTCS services, since the provision of tail-end DTCS is not effectively competitive (as the ACCC determined through the same comprehensive assessment of the state of competition).
- 4.49 This means that there is effectively no competitive tail-end pricing which can form the source data for the regression. So the approach would need to be modified before being applied to tail-end DTCS services.

NBN POIs

Should pricing on deregulated NBN POI routes be considered separately in undertaking the regression analysis for the next FAD?

- 4.50 The pricing of transmission on NBN POI routes should be included in any modelling if there is evidence that these routes are competitive. In addition, the ACCC should seek input on the pricing of transmission services Telstra provides to NBN Co under the Definitive Agreements.

Time period of FAD

What is an appropriate time period for the next FAD?

- 4.51 Optus submits that the FAD should be subject to frequent review given its history of significant regulatory error. To ensure that the FAD pricing remains relevant, a more frequent review of pricing terms should occur until the ACCC can establish a more settled and rigorous data set. Optus considers that the next FAD should apply for 12 months only.