Submission to ACCC on DTCS pricing principles review

July 2010

1. Executive Summary

The Competitive Carriers' Coalition (**CCC**) welcomes the opportunity to make this submission to the Australian Competition and Consumer Commission (**ACCC**) in response to the ACCC's discussion paper entitled *Domestic Transmission Capacity Service – An ACCC Discussion Paper reviewing pricing of the domestic transmission capacity service* (**Discussion Pape**r).

The ACCC has stated that the main purpose of the Discussion Paper is to seek submissions on different approaches for pricing the Domestic Transmission Capacity Service (**DTCS**) to assist the ACCC in determining an appropriate pricing approach for the DTCS, that is flexible enough to be compatible with both the existing access regime under Part XIC of the *Trade Practices Act 1974* (Act), and the access regime proposed under the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009* (**Stated Objective**).

The CCC believes that the time is ripe for change. Telstra's charges for the DTCS particularly on routes where Telstra does not face effective competition are well in excess of any measure of reasonable costs. This is the case even where costs are calculated based on a total service long run incremental costs plus common costs basis (**TSLRIC+**). Notwithstanding this, the CCC agrees with the views expressed by many commentators including the ACCC and the Australian Competition Tribunal (**Tribunal**) and Frontier Economics that TSLRIC+ is no longer an appropriate pricing principle or at the very least, the way TSLRIC+ is implemented can be improved.

The CCC's primary submission is that the ACCC should move away from relying solely on TSLRIC+ as a pricing principle for DTCS. The Discussion Paper lists five alternative pricing principles to TSLRIC+. Of these, the CCC supports option five, a combined approach that adopts a mix of the suggested pricing approaches. The CCC firmly believes that this combined approach must be adopted by the ACCC in order to achieve the Stated Objective and increase competition in the DTCS market. This combined approach should triangulate the following cost based approaches:

- the bottom-up forward looking long-run incremental costs;
- top-up down fully allocated cost approach using a regulated asset base; and
- benchmarking of prices – international and domestic,

(**Combined Pricing Principle**).

The CCC supports the Combined Pricing Principle because:

- it is clear that a forward-looking TSLRIC+ approach is not appropriate, given that many of the routes covered by the DTCS exhibit natural monopoly characteristics and accordingly build/buy signals do not come into play;
- the Combined Pricing Principle will remove some of the inequity in the existing pricing methodology which has constrained DTCS competition;
- the Combined Pricing Principle provides the flexibility required to meet the ACCC's Stated Objective; and
- the inclusion of a benchmarking approach in the Combined Pricing Principle will provide important guidance in determining the appropriate pricing for DTCS.

The CCC notes that the ACCC has recommended that interested parties should read the Frontier Economics paper entitled Transmission Capacity Report dated June 2009, (**ACCC Frontier Paper**) in conjunction with the Discussion Paper.

However, the CCC is of the view that in addition to the ACCC Frontier Paper, the more recent Frontier Economic Paper dated February 2010 and prepared for the Competitive Carriers' Coalition in response to the Access Pricing Principles for Fixed Line Services review (**CCC Frontier Paper**) is also of relevance to this review. In particular, the CCC supports the views expressed by Frontier Economics in the CCC Frontier Paper including the recommendation that "the ACCC should move away from continually re-valuing the assets used to provide the regulated services on a forward-looking basis, and instead lock in a RAB [regulated asset base] and value new capital investments at their actual cost." [1]

The CCC urges the ACCC to adopt the Combined Pricing Principle as a matter of urgency. Presently, Telstra's wholesale prices for DTCS are excessive on non-competitive routes. It appears to the CCC that on these uncompetitive routes Telstra has set its pricing at a level which enables it to derive monopoly rents. Further, even on competitive routes Telstra's DTCS wholesale prices are excessive to the point that competitive operators rarely acquire DTCS from Telstra on these routes.

In many cases it appears to the CCC that Telstra's DTCS prices on uncompetitive rates have been set at rates above that charged by Telstra for equivalent retail services.

In this submission the CCC also argues its case for the ACCC to seek to cost and set regulatory prices for the DTCS based on point-to-point links rather than a ring structure. The CCC considers that setting regulatory prices for DTCS based on a ring structure would result in a severe distortion of pricing for a number of reasons, not the least because the Service Description for DTCS does not require redundancy. In addition, Telstra itself, in many cases, provides DTCS services on a non redundant basis.

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2. Key Points

This section sets out the CCC's key submissions in support of adopting a Combined Pricing Principle and for measuring costs on a point-to-point basis.

2.1 Forward-looking TSLRIC+ is no longer appropriate

Telstra's current DTCS prices are well in excess of reasonable costs based on a forward-looking TSLRIC+ pricing principle. Notwithstanding this, the CCC believes that TSLRIC+ is no longer an appropriate pricing principle for DTCS.

This position is supported by the Tribunal's recent comments regrading TSLRIC+ in its recent decision rejecting Telstra's Unconditioned Local Loop Services Undertaking where it held:

> *...the Tribunal's difficulty with the submissions presented to it on TSLRIC+ goes deeper than the specifics of the TEA Model. It is troubled by the notion that prices should be set on the basis of hypothetical competition for a market that has natural monopoly characteristics, just as it would be puzzled by a proposal to price access to an electricity distribution network in a way intended to cause users to choose whether or not to overbuild the whole network, replacing it completely. Quite separately, the Tribunal notes that the ACCC proposes to examine TSLRIC+ as part of its review of pricing principles. The Tribunal encourages that review and the consideration by the ACCC of alternative pricing*

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[1] Frontier Economics Access Pricing Principles for Fixed Line Services Principles – A Response to the ACCC's Discussion Paper Prepared for the CCC at vii of the Executive Summary.

> *regimes, for example whether pricing on the basis of depreciated optimised replacement cost might be appropriate.*[2]

The need to reconsider TSLRIC was also considered in the CCC Frontier Paper. The CCC supports the central recommendation by Frontier that while the TSLRIC may still have some application as a cost concept, the way it is implemented can be improved. In particular:

> *There is, however, room for the ACCC to improve the way it sets prices so that they are more consistent with the long-term interests of end-users. For instance, our report finds that the ACCC should move away from continually re-valuing the assets used to provide the regulated services on a forward-looking basis, and instead lock in a RAB and value new capital investments at their actual cost....While TSLRIC has typically been measured using forward-looking costing techniques by the ACCC and other overseas regulators in the past, other measures – such as depreciated historic cost (DHC) and depreciated optimised replacement cost (DORC) – can also be used to help estimate a TSLRIC price.*[3]

2.2 The CCC agrees with the Tribunal and Frontier Economic's recommendation that the ACCC should consider alternative pricing regimes. In particular, the CCC favours a RAB based approach calculated based on DHC for the reasons that are detailed in the CCC Frontier paper. The Combined Pricing Principle will remove inequity and increase competition in the DTCS market

The CCC believes that Telstra has a practice of loading costs onto non-competitive routes, thereby artificially inflating the price for those routes. The ACCC needs appropriates mechanisms to insure that costs are evenly spread across routes. A Combined Pricing Principle would provide such a mechanism. In particular, benchmarking of non-competition routes against equivalent competitive routes will assist with this issue.

2.3 A Combined Pricing Principle provides flexibility

The ACCC has clearly stated that it requires a pricing principle that is flexible enough to be compatible with both the existing access regime under Part XIC of the Trade Practices Act 1974 (Act), and the access regime proposed under the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009*. The CCC submits that a Combined Pricing Principle which combines a number of approaches is the only option which can provide the level of flexibility required by the ACCC.

2.4 Benchmarking provides an important cross-check

The CCC strongly agrees with the ACCC's views expressed in the Discussion Paper [at 5.5] that international and domestic benchmarking as well as domestic benchmarking of competitive routes may be useful in determining the regulated price of the DTCS.

Benchmarking is a central feature of the Combined Pricing Principle. Where there is multiplicity of routes (as with DTCS), pricing principles are open to manipulation and distortion. Accordingly benchmarking is an appropriate tool to triangulate the bottom-up forward looking long run incremental costs and top-up forward looking long run incremental costs.

The CCC readily acknowledges that it can be difficult to source appropriate international benchmarking data. However, the CCC believes it is possible for the ACCC to obtain appropriate information from comparable OECD countries for the purposes of benchmarking. New Zealand provides a working example that comparable OECD countries can be used for

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[2] J JR Mansfield, R Steinwall and RF Shogren in *Application by Telstra Corporation Limited ABN 33 051 775 556 [2010] ACompT 1* (10 May 2010) at 239.

[3] Frontier Economics Access Pricing Principles for Fixed Line Services Principles – A Response to the ACCC's Discussion Paper prepared for the CCC at vii of the Executive Summary.

the purposes of benchmarking. The CCC is also of the view that many of the arguments that are commonly made regarding geographical differences between Australia and other countries are vastly overstated. This is illustrated, for example, by the finding of the recent NBN Implementation Study which found that a fibre to the premises network could be feasible to 93 per cent of the Australian population.

In addition to international benchmarking, domestic benchmarking provides an important feature of a Combined Pricing Principle. The CCC believes that Telstra's own prices which it charges on competitive routes will provide useful guidance to the actual costs for DTCS.

2.5 The CCC supports a Point-to-Point rather than Ring Structure

One of the fundamental questions posed in the Discussion Paper (on page 10) is whether the ACCC should seek to cost and set regulatory prices for the DTCS based on ring structures, point-to-point links or some other network design. The CCC is strongly in favour of the ACCC setting regulatory prices for the DTCS based on a point-to-point links rather than a ring design.

One of the primary reasons DTCS should be costed on a point-to-point basis is that the service description for DTCS does not contemplate or require redundancy. That is, DTCS is "a service for the carriage of certain communications from one transmission point to another transmission point." An Access Provider is only required to provide a point-by-point service and has no obligation to provide redundancy. Accordingly, it would be illogical to set regulatory prices for the DTCS based on ring structures when there is no requirement in the Service Description for an Access Provider to deliver the benefits of redundancy to access seekers.

In addition, while Telstra's network design may be based on a ring design, other Access Provider networks are not structured on this basis. Accordingly it would be inappropriate to set regulatory prices for the DTCS based on ring structures when in practice many Access Providers do not, and are unable to, provide services based on a ring structure.

A point-to-point approach is also supported by the fact that Telstra in many cases provides DTCS on a non-redundant basis. Telstra's default position for some DTCS services is to provide DTCS via a "single-path (i.e., not geographically diverse)". Accordingly, in the event that the ACCC cost and set regulatory prices for the DTCS based on ring structures, the price for DTCS would be grossly inflated and access seekers would effectively be required to pay for redundant services which they do not receive.

The CCC respectfully submits that this would create an absurd and unacceptable outcome. It is clear to the CCC that redundant services are an additional "add-on" service which fall outside the scope of the DTCS Service Description and should not be taken into consideration in the pricing of DTCS.

2.6 The CCC supports a RAB based on DHC approach

The CCC firmly supports the recommendations in the CCC Frontier Paper that when implementing TSLRIC "the ACCC should move away from continually re-valuing the assets used to provide the regulated services on a forward-looking basis, and instead lock in a RAB [regulated asset base] and value new capital investments at their actual cost."[4]

[4] Frontier Economics Access Pricing Principles for Fixed Line Services Principles – A Response to the ACCC's Discussion Paper Prepared for the CCC at vii of the Executive Summary.

The CCC supports the view that when assessing RAB, it would be appropriate to adopt a DHC approach because the major advantage of the DHC approach is that it would provide a logical and consistent path towards an ongoing RAB methodology[5].

[5] Frontier Economics Access Pricing Principles for Fixed Line Services Principles – A Response to the ACCC's Discussion Paper Prepared for the CCC at page 19.