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Grant Young
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Australian Competition and Consumer Commission
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Dear Grant

Pricing Principles for Declared Transmission Capacity Services

Optus welcomes the opportunity to respond to the ACCC's draft transmission capacity service pricing principles guide.

Optus agrees with the ACCC that TSLRIC is likely to comprise an effective pricing principle for the declared transmission capacity service routes. TSLRIC based on forward-looking costs would:

- Ensure that asset owners have the ability and incentive to maintain their assets, as TSLRIC enables access providers to recover their legitimate costs of service provision.
- Encourage dynamic efficiency by seeking to establish what infrastructure the asset owner has prudently incurred.
- Promote long-run allocative efficiency by providing price signals that reflect the long-term value of resources embodied in the service.

Optus recognises that in practice, however, the estimation of TSLRIC prices can comprise a long, complicated process, subject to differing interpretations and challenging data requirements. This has the potential to reduce the capacity of the pricing principles to provide effective guidance in commercial negotiations.

In order to address this concern, the pricing principles should provide as much detailed guidance as possible to maximise the ability of access seekers and providers to anticipate the likely outcomes of an arbitration. Within this context, therefore, Optus recommends that the ACCC:

- Provide additional detail in relation to the approach that it would take in estimating the TSLRIC of a transmission route;
- Provide further clarity with respect to the input parameters that it would use; and

- Release indicative prices for a number of transmission routes.

We would also suggest that, if the ACCC take up these recommendations, that it release another draft pricing principles guide prior to providing a final determination.

Note that many of the issues raised in this letter are specific to routes over which Telstra is the monopoly access provider. This is because, realistically, any access disputes that arise are most likely to be directed towards Telstra's monopoly routes.

Methodological issues

Optus has reviewed the steps that the ACCC has proposed it will use to estimate the TSLRIC of the transmission capacity service. For most part, these steps appear to be reasonable. However, as alluded to above the value of these pricing principles could be significantly enhanced through the provision of further detail within each of these steps.

Optus has therefore identified a number of additional points that the ACCC should consider when finalising its pricing principles guide. These are discussed below.

Whose TSLRIC?

The TSLRIC of an incumbent monopoly provider of a transmission service will differ from that of a marginal entrant. This is because costs vary amongst firms in accordance with a wide range of factors, including, but not limited to: technologies utilised, market share (which drives economies of scale), and economies of scope. In performing TSLRIC estimates, therefore, the question of whose TSLRIC is to be measured becomes of considerable importance.

Where there is a single monopoly provider of transmission services over a particular route, in Optus' view the appropriate TSLRIC is that of an efficient, efficient cost monopolist with 100% market share. This cost will factor in the cost reductions that arise from economies of scale and scope. Arriving at the correct TSLRIC will provide safeguards against the charging of monopoly access prices by the monopolist.

In a market with two or more competitors, however, the issue of whose TSLRIC is to be measured becomes more complicated. Difficulties will invariably arise when attempting to select a single access price to impose on firms with differing unit costs. Further issues arise as a result of the trade-off that exists between the range of criteria that the ACCC must have regard to in arriving at access prices; Optus notes that in some cases the price that will best promote the long-term interests of end-users (LTIE) may lie at odds with the price that will best promote the legitimate business interests of access providers (LBI).

To illustrate, on the one view, on a transmission route where the cost of serving the route reveals increasing returns to scale for the (efficient) volumes, the TSLRIC that would best promote the LTIE may be that of a least cost firm with 100% share, assuming that this low per unit cost is passed through in low prices. This is because with 100% market share, the fixed cost component of the route under consideration will be spread over a greater number of units of output. If there were competition in the market, however, this TSLRIC may fail to fulfil the LBI of access providers that do not have sufficient scale to achieve the per unit cost of access provision as a monopolist. (We note, however, that greater competitive pressures in the market would increase the likelihood of any scale economies achieved being passed through to retail prices).

The ACCC therefore needs to weigh up these trade-offs when selecting the appropriate basis for the TSLRIC calculation. Regardless, however, of the nature of the balance that the ACCC decides to adopt, it must be careful to ensure that this TSLRIC is not based upon the costs that would be incurred by an inefficient access provider. Clearly, the LTIE would be harmed if access prices reflected the costs incurred by a firm utilising inefficient technologies or operating practices.

Averaging of costs over multiple routes

The draft guide indicates that the ACCC does not necessarily anticipate that its costings will be based on cost-drivers specific to each individual route. For example, the ACCC has provided the following explanation of how it would approach defining the relevant market for the purpose of costings:

> "*Specification of the relevant market, service or route into which the transmission element falls (e.g. regional-regional, CBD tails, Melbourne-Morwell) reflecting common functional or volume characteristics*". (Step 1 of ACCC's proposed TSLRIC procedures, page 21).

Optus believes that while cost averaging over multiple routes is appropriate for tail-end transmission (for the reasons discussed below), the ACCC should consider only the costs specific to individual routes for non-tail-end (long-haul) transmission.

In relation to tail-end transmission, Telstra offers to Optus a separate schedule of prices for CBD/ metro, and regional routes. Prices also vary according to the capacity of the lease purchased. Telstra averages the price it charges for tail-end transmission across regions and capacities (or speeds). Consequently, it is highly probable that any tail-end disputes would relate to access prices for a large grouping of routes of common functionality, rather than individual routes.

For non-tail end transmission, on the other hand, it is not clear that grouping transmission routes together for costing purposes is appropriate. The majority of non-tail end capacity Optus purchases is on specified routes. In a dispute we would seek prices consistent with the specified route rather than an average (such as, for example, Townsville to Mount Isa). Averaging costs in order to derive the TSLRIC may not be appropriate because very few routes may share sufficiently similar cost-driver characteristics (such as terrain, volume of traffic carried, distance, and level of efficient excess capacity). There is a risk that use of an averaging approach could yield a TSLRIC for an individual route that diverges significantly from its efficient cost level.

Efficient excess capacity

The ACCC's draft guide proposes that in developing transmission service cost models, it will make an allowance for efficient excess capacity reflecting 'industry norms or best practice'.

This step requires further clarification as there are a number of conceptual and practical difficulties the ACCC may need to address. While we accept that a case exists for averaging tail-end transmission cost drivers (for the reasons discussed above), for the remainder of transmission types the efficient level of excess capacity could vary significantly across routes. To illustrate, the efficient level of excess capacity for a busy transmission route servicing a growing population could differ significantly from that of a low capacity route supplying a small and declining population.

Accordingly, these factors will mean that 'industry best practice' or 'industry norms' may not be a particularly meaningful indicator at the individual route level. Optus believes that determination of efficient excess capacity will need to be determined by the ACCC on a route-by-route basis, based upon expectations of future demand growth, and consideration of demand fluctuations specific to that route. Furthermore, in some instances it may be appropriate to use total available capacity to determine the cost per unit, but in others this will lead to inflated costs.

Optus will continue to investigate this issue, and will report back to the ACCC at a later date on the range of values that we believe to comprise efficient levels of excess capacity for tail-end transmission routes.

Pricing for capacity

The final step in the ACCC's proposed methodology involves deriving a unit price for the transmission capacity service. The ACCC has not yet specified, however, how it would approach costing transmission leases of different capacities over individual routes.

By way of background, because of the existence of fixed costs in transmission services, access prices (and costs) generally take on the form of a logarithmic function in terms of the amount of capacity purchased, rather than linear. To illustrate, the following table shows the ratio of prices charged by Telstra for leases of different capacities.

Capacity price ratios

[Table: Commercial-in-confidence]

The issue of capacity price relativities is topical. **[Start: commercial-in-confidence]**
[End: commercial-in-confidence]

In order to enhance the effectiveness of the pricing principles, the ACCC will need to develop a methodology for costing transmission leases of different capacities over individual routes. This will most likely require estimates to be made of the capacity-dependent component of the cost of providing access to transmission services.

Further, Optus believes that the market would benefit significantly from clarification of the ACCC's views regarding the appropriate ratio of prices for tail-end transmission according to the amount of capacity purchased. Specifically, the ACCC should provide a view on what it believes to be an efficient price ratio of an 8 Mb/s lease compared to that of a 2 Mb/s lease or a 34 Mb/s lease.

Optus will investigate this issue further internally, then report back to the ACCC on the extent to which the costs of tail-end access provision generally rise as capacity is increased.

USO adjustments

Optus reiterates the need for the ACCC to make adjustments for USO costs when estimating TSLRIC costs to cater for the fact that a portion of the cost of transmission has been funded not by Telstra *per se*, but by the USO.

As discussed in Optus' October 2003 submission *Transmission Capacity Service,* because the USO provides for the provision of certain telephony services to net cost areas (NCAs), it has necessitated the building of network infrastructure to NCAs. Therefore, the costs of the USO reflect the costs of building and maintaining that infrastructure.

To the extent that many of Telstra's monopoly transmission routes fall within NCAs, the network costs of transmission over those routes should not be recoverable by Telstra.

Optus notes that the provision of non-USO services over the USO funded transmission routes will have required additional investment by Telstra in capacity over and above the capacity required to fulfil the USO. These costs should be recoverable by Telstra through access prices. However, the level of recoverable costs must be limited to the costs incurred by Telstra of expanding capacity over the existing (USO funded) transmission infrastructure. Access prices should not reflect any of the initial infrastructure roll-out costs.

WACC parameters

The issue of what is the appropriate WACC for access pricing purposes has traditionally been a topic subject to much contention. In the interests of providing as much guidance as possible to access seekers and providers, therefore, the ACCC should specify the values that it would adopt, or approaches it would take, with respect to the following WACC input parameters:

- Risk free rate
- Market risk premium
- Taxation rate

- Gearing ratio
- Equity beta
- Imputation factor.

In instances where it is not appropriate for the ACCC to provide specific values for individual WACC input parameters, the ACCC should provide a detailed specification of the approach it would adopt to arrive at the appropriate values.

To illustrate, in relation to the risk free rate we would expect the ACCC to provide details such as: the risk free rate that it would use (for example, would the ACCC use a three-year or a ten-year government bond), and the period of averaging that it would use to correct for on-the-day fluctuations. In relation to the tax rate, we would expect the ACCC to specify whether it would adopt an effective or a statutory rate of taxation.

Use of indicative prices

In addition to the above, Optus submits that the market would benefit significantly from the ACCC providing indicative prices for a range of transmission routes. This would bring a further level of certainty to commercial negotiations and help ensure efficient and effective outcomes from access price negotiations.

The release of indicative prices at the same time as the confirmation of a pricing principle for transmission services would also be consistent with ACCC's recent practices in relation to other declared services including PSTN, local carriage services and mobile termination.

Given the resource intensive nature of such a task, the ACCC would need to identify the routes over which indicative prices would deliver maximum benefit to industry participants. Optus has considered this issue and has formed the view that indicative prices over the following routes would best meet this criteria:

- Tail-end transmission of various distances for CBD/ metro and regional areas; and
- A sample of routes for which there is a monopoly access provider.

Further, the ACCC should provide a view on the appropriate relativity of prices between 2 Mb/s services and those of higher capacities.

Each of these points is now discussed in more detail below.

Tail-end transmission

As outlined earlier, Telstra currently prices tail-end transmission on the basis of distance, with a separate schedule of prices for CBD/ metro and regional routes.

Given that tail-end transmission comprises a large proportion of total transmission services purchased by access seekers, combined with the fact that price structures have emerged such that any access disputes are likely to relate to prices offered over multiple routes, the provision of indicative prices by the ACCC for a range of distances and capacities for both CBD/ metro and regional leases could be well justified. This would comprise a cost effective way of providing guidance to the market covering a large proportion of all transmission services. It would also assist commercial outcomes and potentially reduce the need for further regulatory intervention.

Sample of monopoly routes

It is well known that pricing disputes are most likely to arise in instances where the access service is controlled by a monopolist. The ACCC should therefore consider providing indicative prices for specific monopoly routes. Optus has identified the following routes as being appropriate candidates for indicative prices on the grounds that these are monopoly routes over which relatively high volumes of transmission services are purchased. Optus suspects that the current access prices charged for these routes exceed the TSLRIC:

- Townsville – Mount Isa;
- Darwin – Alice Springs;
- Melbourne – Mildura; and
- Perth – Karratha.

Optus would be happy to provide guidance to the ACCC on other monopoly routes which would benefit from indicative prices should it wish to investigate this option further.

Should you have any questions relating to any elements of this letter, please do not hesitate to contact me on (02) 9342 7036 or Sara Whyte on (02) 9342 5125.

Yours sincerely

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