

**PUBLIC VERSION OF TELSTRA'S SUBMISSION IN RESPONSE TO  
THE AUSTRALIAN COMPETITION AND CONSUMER  
COMMISSION'S DRAFT DECISION ON TELSTRA'S ULLS AND LSS  
MONTHLY CHARGES UNDERTAKINGS**

**ANNEXURE F**

**RESPONSE TO ACCESS SEEKER SUBMISSIONS**

**INTRODUCTION**

- 1 Access Seekers have provided submissions to the Commission in response to its ULLS Discussion Paper and LSS Discussion Paper.
- 2 In this Annexure, Telstra responds to matters raised by the Access Seekers in respect of the prices set out in Telstra's ULLS Monthly Charges and LSS Monthly Charges Undertakings. Telstra will respond separately to matters raised by the Access Seekers in respect of Telstra's ULLS Connections Charges and LSS Connection Charges Undertakings.

**CONFIDENTIALITY**

- 3 This annexure has all of the confidential information deleted and thus may be disclosed publicly. Telstra will provide the confidential version of this annexure and the confidential information contained in it to interested parties upon those parties signing appropriate confidentiality undertakings.

**ACCESS SPECIFIC COSTS**

- 4 In its Draft Decision, the Commission concludes that for both ULLS and LSS, access specific costs should be spread across a broader range of services.
- 5 In its ULLS and LSS Discussion Papers, the Commission asked for submissions on what would be reasonable demand estimates for ULLS and LSS for 2004/05 and 2005/06 and on the appropriate cost recovery method for access specific costs (including how historical costs should be dealt with, and over what services access specific costs should be recovered).
- 6 Telstra responds to the Access Seeker submissions on these matters in the paragraphs below.

## Demand Estimates

- 7 The CCC commissioned Gibson Quai - AAS Pty Ltd (“**Gibson Quai**”) to prepare a report on the CCC’s behalf. Gibson Quai relies on demand estimates for ULLS of 201,000<sup>1</sup> and 400,000<sup>2</sup> for the period ending June 2005 in calculating \$8.61 as an appropriate ULLS monthly charge.<sup>3</sup> For LSS, Gibson Quai relies on an estimate of 237,035 for the same period. These forecasts respectively overestimate actual demand by “c-i-c” and “c-i-c” for ULLS and “c-i-c” with respect to LSS due to the fact that “c-i-c” ULLSs and “c-i-c” LSSs were actually provided for the period ending June 2005. It is Telstra’s view that Gibson Quai’s forecasts for subsequent years are greatly exaggerated by this initial error.
- 8 As identified above, the actual service numbers for ULLS and LSS for the 2004/2005 period are much closer to the Telstra forecasts of “c-i-c” and “c-i-c” respectively and, in the case of ULLS, are also lower than Telstra’s forecast for the period. At July 2005, the actual demand for ULLS was “c-i-c”, again less than Telstra’s supposedly conservative forecast.
- 9 Macquarie says that the uptake of ULLS to date has been slower than forecast demand and that it expects ULLS uptake to now rapidly overtake projected demand. Telstra agrees with Macquarie’s claim that the uptake of ULLS to date has been slower than predicted. However, in relation to Macquarie’s expectation that ULLS uptake will now rapidly overtake projected demand, Telstra submits that its demand forecast for ULLS has already taken these growth factors into consideration.
- 10 Gibson Quai comments that Telstra’s demand estimates are significantly lower than other estimates.<sup>4</sup>
- 11 Telstra acknowledges that its estimates are lower than other estimates. However, as noted above, Telstra’s demand estimate numbers are much closer to actual numbers for the period 2004/05 than the Gibson Quai and Commission estimates. This is because Telstra’s forecasts are based on actual operational information rather than market variable extrapolation. Gibson Quai claims that there has been uncertainty around the appropriate pricing for LLS and it relies on this, and other matters, to support its claim that the

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<sup>1</sup> Relying on potential demand as estimated by “two of the major Australia ISP’s”, Primus and iiNet (see CCC Submission, page 32).

<sup>2</sup> The Commission’s previous estimate of ULLSs.

<sup>3</sup> CCC Submission, page 4.

<sup>4</sup> CCC Submission, page 30.

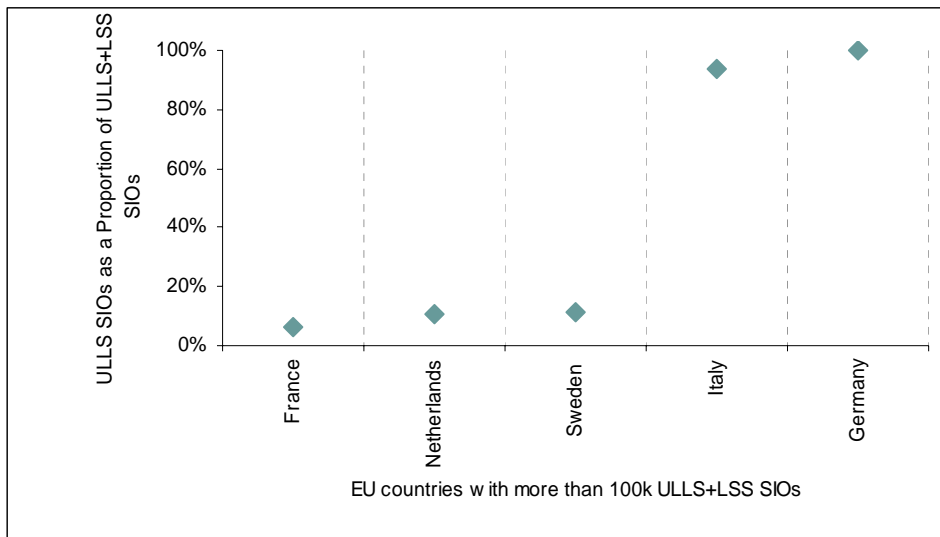
demand estimates applied in cost modeling should ignore the historical take up of the service.

- 12 Telstra agrees with Gibson Quai that demand estimates should be based on sound forward looking reasoning, appropriate research and careful analysis, as outlined in Telstra's submissions in support of its ULLS and LSS Monthly Charges Undertakings. However, Telstra submits that historical data needs to be taken into account in making sound forecasts of demand. Indeed it is almost universally taken into account when any demand forecast is made. To ignore history entirely (as advocated by Gibson Quai) would result in a baseless forecast not anchored in reality. Perhaps it is because Gibson Quai ignored historical experience that it forecast LSS demand to be 237,035 and ULLS demand to be 201,000 for the period ending June 2005 when in fact demand was only "c-i-c" and "c-i-c", respectively. These differences between the forecasts and actual demand clearly undermine Gibson Quai's forecasting approach.
- 13 Gibson Quai claims that future demand for LSS will be driven by:
- (a) economic feasibility (of migrating customers to LSS); and
  - (b) natural growth in demand for broadband services within Australia.<sup>5</sup>
- 14 Telstra concurs with this view but as set out in the statement of "c-i-c", dated 26 May 2005, we note that Telstra's forecasts take into account the expected volume of managed network migrations.
- 15 While growth in demand for ADSL might affect LSS demand, Telstra does not necessarily agree that such an effect will be significant. There are many factors that may affect the success of LSS. For example, the availability of substitutes, notably ULLS, could result in low demand for LSS regardless of growth in demand for broadband services more generally. In any event, Telstra does take into account growth in demand for ADSL through the organic growth component of the forecast for LSS.
- 16 Gibson Quai also forecasts that demand for each of ULLS and LSS will be relatively balanced. However, this is contradicted by international experience, which shows that where access seekers supply retail xDSL, it is not usual for demand for ULLS and demand for LSS to *both* be high. That is, there is either a high demand for ULLS and low demand for LSS, or a low demand for ULLS and high demand for LSS. For example, in European countries where demand for ULLS plus LSS is over 100,000 services, demand

is asymmetric. Figure 1 below illustrates this. In France, the Netherlands and Sweden, the demand for ULLS as a percentage of total demand for ULLS plus LSS is less than 12%, while in Italy and Germany it is over 93%. This evidence suggests that in reality it is likely that future demand for either (and not both) ULLS and LSS will be high in Australia. The markets for ULLS and LSS in Australia are only in the early stage of the growth phrase. As such the current trends are still in their infancy.

- 17 The weighting in favour of either ULLS or LSS occurs largely because ULLS and LSS are such close substitutes<sup>6</sup>, thus once ISPs establish which of the two approaches is more appropriate for their needs, that approach dominates. Clearly, the modelling that Gibson Quai undertook of ULLS and LSS demand failed to take account of this similarity between the two wholesale services.

Figure 1: Comparison of the ratios of ULLS demand to ULLS+LSS demand in European countries



- 18 Telstra also notes that the data underlying Gibson Quai’s forecast is inconsistent with public information released by the CCC’s own members. For example, Gibson Quai claims that the iiNet estimate for LSSs at June 2005 was 97,200. Further, it claims that “the iiNet estimates have been derived from a publicly available document”. However, iiNet’s press releases show that iiNet’s demand for LSS was much lower than this. In particular, in March 2005 iiNet claimed it had 22,000 LSSs.<sup>7</sup> On 10 June 2005, iiNet claimed it had over 28,000 services on its DSLAMs<sup>8</sup>, and that this was increasing at a rate

<sup>5</sup> CCC Submission, page 31.

<sup>6</sup> This was one reason given by the Federal Communications Commission in the US for dropping regulated access to LSS.

<sup>7</sup> [http://www.iinet.com.au/news/dslam\\_expansion.pdf](http://www.iinet.com.au/news/dslam_expansion.pdf).

<sup>8</sup> [http://www.iinet.com.au/about/investor/announce\\_adsl2.pdf](http://www.iinet.com.au/about/investor/announce_adsl2.pdf).

of 1500 services over a three-week period.<sup>9</sup> In a public document, dated 30 August, iiNet reported that as at 30 June 2005, it had 35,000 customers on its DSLAMS.<sup>10</sup> These actual customer numbers released to the market by Australia's third largest ISP suggest that Gibson Quai's demand forecast for LSS are inaccurately high.

- 19 In contrast to Gibson Quai's demand forecasts, Telstra's ULLS and LSS demand forecasts are informed by market growth forecasts, access seeker operational demand forecasts and historical Australian trends data. Telstra's demand forecast methodologies have also been tested against alternative forecasting methodologies. Details of these studies have been submitted to the Commission in Telstra's submission in support of the ULLS Monthly Charges Undertaking dated 3 March 2005 ("**March Submission**").<sup>11</sup> Moreover, Telstra has much stronger incentives to generate accurate forecasts as it has to meet demand for its ULLS and LSS services (as has been born out in practice). Consequently, Telstra's forecasts can reasonably be expected to be more accurate than those of Gibson Quai.<sup>12</sup>

### **Macquarie allegations**

- 20 Macquarie alleges that the prices set out in the ULLS Monthly Charges Undertaking and the justification provided by Telstra for them are an attempt by Telstra to stifle the development of true competition in the CAN through the use of ULLS, and that Telstra is attempting to discourage the take up of ULLS by discriminating against access seekers in favour of its own wholesale and retail DSL services.<sup>13</sup> Telstra rejects these allegations and notes that Macquarie does not substantiate these allegations with any evidence.
- 21 Telstra also rejects Macquarie's claim that Telstra is delaying the deployment of new broadband technologies, and that the delay, relative to other countries, is "*clearly sheeted home*" to the different levels of competition and/or policy settings. This claim is misguided. Telstra is constantly considering future technology options, including ADSL2+, fibre to the home or curb, wireless broadband, 3G etc.
- 22 Furthermore, to invest in a particular technology too early can lead to a very expensive mistake, hence appropriate commercial caution is warranted. It follows that if technology adoption is delayed in Australia relative to other countries, this is not necessarily because of competition and policy settings, but more likely reflects prudent investment decisions in unproven technologies.

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<sup>9</sup> <http://www.iinet.com.au/about/investor.html>.

<sup>10</sup> [http://www.iinet.com.au/about/investor/year\\_end\\_presentation.pdf](http://www.iinet.com.au/about/investor/year_end_presentation.pdf).

<sup>11</sup> See Annexures E and F to the 3 March 2005 Submission.

- 23 The sample of countries relied upon by Macquarie does not support Macquarie's conclusions. For example, Hong Kong and Denmark are considerably more densely populated than Australia and consequently the costs of investments stranded by technology in those countries are likely to be considerably lower than in Australia.<sup>14</sup> Even Canada's average line density is over 60% higher than Australia's.<sup>15</sup> Further, in Canada, the Canadian Government has offered substantial subsidies to broadband suppliers, which are likely to lower the cost of deploying new broadband technologies.<sup>16</sup>
- 24 In Australia, Telstra announced in March that it was investing \$210m to upgrade its network for ADSL2+ technologies.<sup>17</sup> To say this is slow or due to competition and policy problems is without substance. Telstra is in a similar position to other comparable countries in terms of ADSL2+ deployment.<sup>18</sup>

### **Cost Inputs**

#### Historical Capex

- 25 AAPT argues that it would be appropriate for the Commission to adopt an expansive definition for both ULLS and LSS so that there are no ULLS or LSS specific costs and "*all such costs are just considered to be common costs of the CAN*".<sup>19</sup> AAPT claims that what leads it to believe that ULLS and LSS specific costs are common to the CAN is its (incorrect) view that:

*"there is no circumstance under which Telstra could offer retail DSL services without offering the LSS. That is, the LSS-specific costs are increments to the decision to offer DSL, and it is this decision that necessitates the offer of LSS".<sup>20</sup>*

- 26 While Telstra must split the frequency of the electromagnetic signal carried on the copper CAN (into an upper band to be used for DSL and a lower band to be used for voice) to offer retail DSL services, Telstra can and does offer retail DSL services and LSS (and

<sup>12</sup> See also Telstra's comments in Telstra's Response to ULLS and LSS Discussion Papers.

<sup>13</sup> Macquarie Submission, page 2.

<sup>14</sup> For example, fixed line densities in Hong Kong and Denmark are 85.16 and 3648.08, respectively. In comparison, Australia's average line density is 1.33. See *CIA World Factbook*, <http://www.cia.gov/cia/publications/factbook/>.

<sup>15</sup> Canada's average line density is 2.19. Australia's is 1.33. See *CIA World Factbook*, <http://www.cia.gov/cia/publications/factbook/>.

<sup>16</sup> For example, in the latest round of funding, the Ministry for Industry aims to provide C\$79m in subsidies for companies deploying broadband in rural communities. See <http://broadband.gc.ca/pub/program/about.html>.

<sup>17</sup> [http://www.telstra.com.au/abouttelstra/media/mediareleases\\_article.cfm?ObjectID=33436](http://www.telstra.com.au/abouttelstra/media/mediareleases_article.cfm?ObjectID=33436).

<sup>18</sup> In March 2005, BT announced employee trials of ADSL2+ (<http://www.btplc.com/News/Articles/ShowArticle.cfm?ArticleID=0b2c14fe-1fb5-4587-b5e2-0e78af0426b6>).

<sup>19</sup> AAPT Submission, page 5.

indeed did offer retail DSL services before it offered a LSS service to access seekers). The first retail DSL service was offered in August 2000<sup>21</sup>, almost two years before LSS was offered in July 2002.<sup>22</sup>

27 AAPT also states that:

*“any costs incurred by Telstra in providing LSS are not incremental to the provision of LSS ... the continuation of this argument to encompass ULL and calling products, results in the conclusion that the so-called ULL and LSS-specific costs are indeed CAN common costs.”*<sup>23</sup>

28 As set out in the statement of “c-i-c”, dated 20 September 2005, the LSS specific costs are directly attributable to LSS and are not shared with any other Telstra services. As such they should be recovered from LSS users.

29 AAPT concludes that if Telstra offers retail DSL services, it could offer ULLS and LSS without incurring any additional costs. This is incorrect. AAPT and, in particular, its parent company Telecom New Zealand have previously investigated what support systems are necessary to provide ULLS. AAPT’s comments in its submission to the Commission are contrary to its views in New Zealand. In particular, AAPT’s parent argues:

*“It is important to note however, that while [pre-ordering, ordering and provisioning, fault handling and billing activities] are required to support every telecommunications service, the complexities involved in providing them differ depending on the type of service. In particular, while the same end-to-end processes can be used for retail and wholesale services, unbundled services require that new processes and systems be commissioned and implemented.”*<sup>24</sup>

30 This supports the proposition that there are ULLS and LSS specific costs that should be recovered from ULLS and LSS prices. It also contradicts AAPT’s view that ULLS and LSS costs should be treated as common costs of the CAN.

31 In addition, in reviewing a ULLS cost benefit model, AAPT’s parent claims:

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<sup>20</sup> AAPT Submission, page 5.

<sup>21</sup> [http://www.telstra.com.au/abouttelstra/media/mediareleases\\_article.cfm?ObjectID=7941](http://www.telstra.com.au/abouttelstra/media/mediareleases_article.cfm?ObjectID=7941).

<sup>22</sup> [http://www.telstra.com.au/abouttelstra/media/mediareleases\\_article.cfm?ObjectID=20821](http://www.telstra.com.au/abouttelstra/media/mediareleases_article.cfm?ObjectID=20821).

<sup>23</sup> AAPT Submission, page 5.

<sup>24</sup> Telecom NZ (2003), “Telecom’s Response to the Commerce Commission’s Draft Report”, 29 October 2003, at paragraph 1057.

*“Under a TSLRIC model, 100% of the fair and reasonable costs should be borne by entrants to ensure that inefficient entry does not occur through a circuitous subsidy. This is the situation in Australia, which operates a very similar TSLRIC methodology to New Zealand.”*<sup>25</sup>

32 This is in direct contrast to AAPT’s view that ULLS and LSS costs should be recovered over all CAN services and be partially subsidised by the access provider.

33 AAPT refers to its previous claim that a cost allocation method which concludes there are no LSS or ULLS specific costs mitigates the incentives for Telstra to raise the costs of its competitors in the downstream DSL market through non-price discrimination (also referred to in the economics literature as “sabotage”).<sup>26</sup> Telstra emphatically denies that it is ‘sabotaging’ its rivals and responds to AAPT’s review of the economics of sabotage in Attachment A to this Annexure.

34 Telstra also queries AAPT’s concern about ULLS pricing more generally, given claims by AAPT’s parent company, in a section titled *“The tide has turned on [ULLS] - yesterday’s failed solution”*, that:

*“Other regulators overseas, like the [New Zealand Commerce] Commission, are beginning to recognise that regulated unbundling is not necessarily the most effective solution to a perceived access bottleneck.”*<sup>27</sup>

35 In a separate report, AAPT’s parent company states:

*“New Zealand must take advantage of the lessons from offshore: line sharing has without exception been a failure in every overseas jurisdiction where it was implemented.”*<sup>28</sup>

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<sup>25</sup> Telecom NZ (2003), “Telecom’s Response to the Commerce Commission’s Draft Report”, 29 October 2003, at paragraph 1129.

<sup>26</sup> *Submission by AAPT Limited in respect to the Assessment of Telstra’s undertakings for PSTN, ULLS and LCS Draft Decision*, dated November 2004.

<sup>27</sup> Telecom NZ Pty Ltd (2004), “Section 64 and Schedule 3 Investigation into Unbundling the Local Loop Network and the Fixed Public Data Network: Telecom’s Cross Submission to the Minister of Communications on the Commerce Commission’s Final Report”, 1 March 2004.

<sup>28</sup> Telecom NZ Pty Ltd (2004), “Section 64 and Schedule 3 Investigation into Unbundling the Local Loop Network and the Fixed Public Data Network: Telecom’s Submission to the Minister of Communications on the Commerce Commission’s Final Report”, 10 February 2004, at paragraph 108.



- 36 Even if these contradictions are ignored and AAPT's arguments are considered on their merits, Telstra rejects AAPT's arguments and refers to and relies on Annexure B regarding the appropriateness of recovery of LSS specific costs as part of the LSS price.
- 37 At paragraph 5.6 of its submission, Optus says that it believes the quantum of ULLS capex claimed by Telstra is well in excess of that which should be claimed by an efficient operator and that it agrees with the Commission that the use of separate ordering and provisioning systems for ULLS is likely to be highly inefficient. Macquarie also argues that an efficient operator would operate an integrated system.<sup>29</sup> On this basis, Macquarie argues that there should be no ULLS specific costs included in the ULLS monthly charge.
- 38 Telstra takes issue with all these assertions. Telstra has addressed the issue of whether ULLS costs are common CAN costs in Annexure D of the Telstra Response to the ULLS Discussion Paper, which discusses whether it is efficient to integrate ULLS specific and other systems, and in its expert report by Henry Ergas "*Expert Report on Recovery of ULLS-specific Costs*" submitted in support of Telstra's Response to the ULLS Discussion Paper.
- 39 Indeed, AAPT's parent company appears to agree with this view when stating, as quoted above, "*while the same end-to-end processes can be used for retail and wholesale services, unbundled services require that new processes and systems be commissioned and implemented*".
- 40 As Telstra has submitted previously, the ULLS provisioning system (ULLCIS) was specified by an Australian Communications Industry Forum ("**ACIF**") committee.<sup>30</sup> Optus' claim that Telstra held considerable influence in the ACIF forum and was responsible for shaping the final design of the system<sup>31</sup> is irrelevant. The specifications were agreed by the industry and accepted by the Commission as being efficient.<sup>32</sup>
- 41 No evidence has been provided by the Commission or Access Seekers as to the incremental costs and efficiency benefits of an integrated system.

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<sup>29</sup> Macquarie Submission, page 3.

<sup>30</sup> March Submission, Annexure D.

<sup>31</sup> Optus Submission, paragraph 5.8.

<sup>32</sup> For example, in *Assessment of Telstra's Undertaking for PSTN, ULLS and LCS: Draft Decision*, October 2004, at page 64, the Commission stated:

*"The Commission believed that certain additional costs were required in setting up the [ULLS] service. In particular development costs, staffing costs and operational costs in the period during which the optimal design was determined [sic]. In part, the Commission took this view because Telstra believed that a separate system was required by the ACIF code."*

42 Optus says that the Commission should audit Telstra's claimed costs against the assessment undertaken by the Communications and Media Policy Institute of the University of Canberra and AAS Consulting Pty Ltd ("CMPI/AAS"). Telstra would be more than happy for the Commission to audit its cost estimates against the CMPI/AAS model provided that the Commission acknowledges and accepts that with the lapse of time there has been significant changes in the demand for ULLS - and hence costs - since the CMPI/AAS model was constructed in 2001.

### **ULLS O&M for IT**

43 Optus says that it finds it difficult to believe there would be any incremental IT O&M costs associated with Telstra's 2005/06 capital expenditure because all that is required is a minor amendment to the ULLCIS system's code to allow it to recognise the new deployment classes. Telstra rejects Optus' assertion. The capex claimed by Telstra for 2005/06 consists of more than a simple table change. Telstra also has to record the change in its cable records and service qualification ("SQ") systems, and in the general ordering interface for service assurance records. Testing is also required across all these interfaces prior to deployment. Optus does not have any of these associated costs.

44 For O&M costs between 2000 and 2005, Optus claims that Telstra is seeking to recover its historic costs rather than recovering forward looking efficient costs, and that the historic costs are likely to diverge considerably from efficient costs due to various inefficiencies that have been built into the ULLS specific IT systems.<sup>33</sup> Telstra is actually seeking to recover historical costs that were backloaded into future demand as a result of the Commission adopting demand forecasts which were too high. Furthermore, Telstra considers that the forward looking efficient cost argument should apply to network elements for which Telstra has sole decision making ability, and not to systems developed by the industry (including Optus) to enable ordering and provisioning at the time of declaration of ULLS. Telstra cannot be required to bear the costs of decisions made by the industry.

45 Optus also refers to its previous submissions on its concerns with ULLCIS. Telstra understands from Optus that it is referring to the following:

- (a) Submission by Cable and Wireless Optus, "*Review of Telstra's ULLS-Specific Cost*" dated August 2001;

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<sup>33</sup> Optus Submission, paragraph 5.26.

- (b) Letter to Commission “*Access dispute between Optus Networks, XYZed and Telstra – Unconditioned Local Loop Services*” dated 20 October 2000 ;
- (c) Optus’ confidential submission “*Telstra’s Undertaking for Domestic PSTN Originating and Terminating Access, Unconditioned Local Loop Service and Local Carriage Service of March 2004*”; and
- (d) Optus’ submission to the Commission “*Model Price Terms and Conditions for PSTN, ULLS and LCS*” of May 2003.

46 To the extent that the Commission considers or relies upon any of the Optus documents identified at (a) to (d) above, or any other Optus document referred to within those submissions, to ensure procedural fairness Telstra should be given an opportunity to respond to these documents in the context of the current undertakings.

#### The connection group costs

47 Optus acknowledges that Telstra is claiming for “c-i-c” staff members for front of house for 2005-06, performing around “c-i-c” connections per day and has compared this with the recommendations made in the CMPI/AAS report. On the basis of the CMPI/AAS report, Optus claims that the Commission should allow Telstra to recover the costs of no more than 10 staff members. Telstra has made submissions to the Commission previously on the inadequacies of the CMPI/AAS report.<sup>34</sup> Telstra has also previously provided information on the work of the ULLS connection group.<sup>35</sup>

#### Wholesale product management costs

48 Optus states that any portion of the product managers’ time attributable to commercial activities that are intended to benefit Telstra, rather than access seekers, should be removed from the pool of costs. Optus argues that any portion of the product manager’s time that is spent on regulatory-related activities that are intended to protect Telstra’s ULLS revenues should not be included.<sup>36</sup>

49 As set out in the statement of c-i-c, dated 26 May 2005, the regulatory activities carried out by members of Telstra’s product management team include assisting the Telstra Regulatory team in relation to access undertakings, assisting with customer disputes and

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<sup>34</sup> See the Telstra Response to ULLS Discussion Paper, paragraphs 14-16.

<sup>35</sup> See Statement of “c-i-c” dated 25 May 2005.

<sup>36</sup> Optus Submission, paragraph 5.3.3.

preparing for and attending briefings of the Commission. The Commission and Telstra encourage an environment where compliance policies and procedures are given the highest priority. The costs of compliance are, for any good corporate citizen and certainly for Telstra, a normal part of doing business. Therefore, Telstra should be allowed to recover compliance costs in the pricing of any service.

- 50 Optus has suggested that only 50% of the costs Telstra is seeking to recover through ULL product management be attributed to the ULL access price – or alternatively the equivalent of one full time product manager.<sup>37</sup> However, Optus provides no supporting evidence for its “conservative estimate”<sup>38</sup> that only 50% of these costs be attributed to the ULL access price.
- 51 Gibson Quai also claims that in the long term Telstra would devolve the wholesale product management function to less skilled staff as the processes are bedded down and that, given the synergies, similarities and relationships between ULLS and LSS, it is likely that Telstra would task a single person to undertake the wholesale product management for both products.
- 52 Telstra disagrees with these claims. As presented in Telstra’s forecasts, demand for ULLS and LSS is likely to increase in the coming years. This will require Telstra Wholesale to have the processes and systems in place to manage the forecasted scale. This is in addition to managing ever increasing customer requests for new enhancements and new processes. Any failure by Telstra to adequately staff these processes and requirements will result in Telstra being accused of inhibiting competition. Accordingly, Telstra’s view is that it is likely to require more resources for wholesale product management, not less.

#### Indirect O&M costs

- 53 Telstra has explained previously the factors employed by Telstra to mark-up direct O&M costs and why they are appropriate.<sup>39</sup> Gibson Quai claims that the costs used by Telstra are not those of an efficient forward looking operator and suggests that international benchmarks would be appropriate.<sup>40</sup> Telstra notes that the methodology used to calculate the overhead costs is set out in the statement of “c-i-c” dated 26 May 2005 (“c-i-c” **statement**) in support of the March Submission. The “c-i-c” statement provides that the

<sup>37</sup> Optus Submission, paragraph 5.3.6.

<sup>38</sup> Optus Submission, paragraph 5.3.6.

<sup>39</sup> See, for example, Annexure C of Telstra’s submissions in support of its ULLS Monthly Charges Undertaking and Statement of “c-i-c” dated 26 May 2005.

<sup>40</sup> CCC Submission, page 36.

total overhead costs are calculated by applying a percentage mark-up to the estimate of labour costs. The use of percentage ratios to derive overhead costs in this way is standard practice in TSLRIC modelling and is an approach the Commission used in the NERA modelling undertaken for the purposes of assessing the costs of providing PSTN originating and terminating access (“PSTN OTA”).

- 54 Use of historical data to derive mark-ups does not mean that the indirect costs are not necessarily efficient or forward-looking. As Telstra has stated previously, to the extent that historical accounts reflect inefficiencies (and Telstra does not necessarily accept that they do), it is reasonable to assume that this will show up in both the numerator (overhead costs) and the denominator (direct costs) used to derive the ratio. The approach of deriving overheads using percentage mark-ups should ensure that the overhead costs represent the costs of an efficient operator.
- 55 Telstra rejects the claim that its overhead cost allowances are excessive and submits that these allowances have been calculated using a methodology consistent with forward looking efficient costs.

#### **Cost recovery - 2005/06 costs**

##### **ULLS**

- 56 Optus has said that it believes Telstra’s cost model approach to calculating an annual cost attributable to 2005/06 from the new capex based on a five year recovery period is inappropriate because:
- (a) levelising over future periods, rather than past periods, will best promote the LTIE by reducing the unit cost attributable to each service, while still allowing Telstra to recover its costs; and
  - (b) the model proposed by Telstra is one that would never be used in a competitively commercial environment and is instead most likely an approach that seeks to game the regulatory system.<sup>41</sup>
- 57 Optus’ suggestion that the 2005/06 costs be allocated to a future levelisation period rather than a past period that extends up until 2005/06 will mean that levelising costs over a period that extends too far into the uncertain future increases the risk of cost over and under recovery. This might mean that access seekers pay too much or too little for ULLS, which increases the risks both Telstra and access-seekers bear (though again with risk

disproportionately falling on Telstra). The end of the undertaking period marks a sensible end point to the levelisation period that extends back to the start of service provision to allow backloaded costs to be recovered. To claim that Telstra's approach to cost recovery is not one that would be used in a competitively commercial environment should be given no weight as Telstra is clearly not operating in an unfettered commercial environment, a key case in point being the mandate to price in earlier periods based on unrealistically high demand forecasts. Besides, this point is entirely unsubstantiated and a mere assertion, with no indication of how and why an access provider would price ULLS in such an environment.

58 Optus also claims that Telstra's interests will not be unduly harmed as levelising forward would still allow Telstra to recover its reasonably incurred costs.<sup>42</sup> However, Telstra believes that levelising previously backloaded costs further into the future will have the effect of further backloading those costs and is not in Telstra's legitimate commercial interests. Telstra has provided capital for the ULLS service, built the ULLS service, and actively provides ULLS to access seekers. It has also played a crucial role in introducing DSL to the general public, which benefits all DSL suppliers. It is now time for access seekers including Optus to pay for the costs of that service, since they are now benefiting from its availability. To suggest that they should not contribute appropriately to these costs is akin to laying a claim that Telstra should subsidise their entry into the market. Additionally, levelising over a period that extends too far into the uncertain future increases the risk of cost over and under recovery raising the risk faced both by Telstra and access-seekers (again with risk disproportionately falling on Telstra).

59 In relation to Optus' claim that levelising forward will lead to the promotion of competition, as discussed above, Optus' proposal is likely to result in previously backloaded costs being further backloaded where it is necessary to bring forward previously unrecovered costs. Greater backloading increases the likelihood that Telstra will not recover its costs. That is, that access-seekers will not pay for the full costs of supplying them with ULLS. This lowers the expected long-term price of ULLS and raises the risks born by Telstra. For example, without adequate compensation in the form of increased ULLS prices, such backloading in effect subsidises ULLS. This will have two related effects. In the short run, when prices are artificially low, excessive entry based on ULLS will be encouraged, while in the long run when cost recovery to be effected, use of

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<sup>41</sup> Optus Submission, paragraphs 6.14-6.15.

<sup>42</sup> Optus Submission, paragraph 6.17.

ULLS will be artificially lowered as access-seekers try to avoid paying for the full cost of ULLS. Inefficient short-term entry based on ULLS will be encouraged and existing non-ULLS based (most notably full facility-based) competitors will be inefficiently disadvantaged related to ULLS based competitors.<sup>43</sup> Worse, Optus may be hoping to establish a principle whereby cost recovery is pushed further and further back in time, but, when it comes time to recover those backloaded costs, the price setting exercise is restarted. In any case, Optus has failed to demonstrate how further backloading already backloaded costs could be in the LTIE. Rather it reduces the likelihood of cost recovery, increases future pricing risks, increases the likelihood that Telstra will not achieve cost recovery and not be compensated for the risk it bore in the process, and will induce inefficient entry and inefficient ULLS usage.

- 60 Optus' concerns that levelising new costs over past demand would be akin to a firm attempting to recover planned future capex through current retail prices<sup>44</sup> are unfounded. In particular, the 'Final Results' worksheet in Telstra's ULLS specific model, which has been available to Optus for a reasonable period of time, clearly shows the levelised price in future periods recovers the annualised cost in those periods plus a proportion of previously backloaded costs. Therefore, it is incorrect for Optus to assume that future costs are recovered from previous demand. Indeed the opposite is true - previously incurred costs are recovered from future demand. Figure 2 illustrates this.

Figure 2: NPV of Annualised ULLS Specific Costs and Revenues

"c-i-c"

Source: Telstra's ULLS Specific Cost Model

- 61 If Optus' suggestion is to now ignore those previously backloaded costs, then this would represent a transfer from Telstra to access seekers, and would prevent Telstra from recovering its efficiently incurred upfront costs.
- 62 Optus argues that levelisation over past periods also creates problems resulting from Telstra's actions that have suppressed past demand.<sup>45</sup> However, as previously noted,

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<sup>43</sup> There would likely be other effects, for example, due to regulatory gaming, as discussed in paragraph 63 below.

<sup>44</sup> Optus Submission, paragraph 6.18.

<sup>45</sup> Optus Submission, paragraph 6.18.

neither Optus or any other members of the CCC have provided evidence in support of the allegation that Telstra has suppressed demand for ADSL services.

- 63 Telstra believes that Optus' proposed methodology of deciding at the end of each five-year period whether any losses could be carried forward is unreasonable and against the LTIE. Moreover, it is against Telstra's legitimate commercial interests. Both the LTIE and Telstra's legitimate business interests require that Telstra should always be entitled to recover its (efficient) forward looking costs. To do so otherwise would create significant uncertainty for investors and discourage long-term efficient investment in Australia's telecommunications networks.
- 64 For example, Optus could argue strongly that ULLS demand will be very high in the first regulatory period, even though it knows it will be low. Prices set on the basis of an exaggerated demand forecast would not allow cost recovery. Optus could also subsequently stall its ULLS network roll out so that actual ULLS take-up is even lower than a realistic forecast would have predicted. Consequently, Telstra would substantially under recover its costs in the first regulatory period. At the end of the first regulatory period, Optus could then argue that Telstra's previously backdated costs should be written off (as it currently is), to secure an even lower ULLS price in the second regulatory period. Then, Optus could build its ULLS network and purchase ULLS at significantly below-cost prices.
- 65 If Optus' proposal results in Telstra not recovering its efficiently incurred costs, then it is not in the LTIE. As discussed previously, it would be inconsistent with the statutory criteria and a very damaging implementation of Australian access policy to prevent Telstra from recovering its efficiently incurred costs.
- 66 In alleging that levelising the 2005/06 new capital costs over current demand levels would have been an improvement on Telstra's approach and would have resulted in a reduction in the attributable new capital costs per service for 2005/06 by almost a third<sup>46</sup>, Optus is again mistaken. Telstra's methodology does levelise 2005/06 capital costs (depreciation and the cost of capital) over current demand levels.
- 67 In response to the CCC's claim that the ULLS specific costs in the period following 2005/06 should be \$2 to \$3 per service<sup>47</sup>, Telstra submits that it is inappropriate (and in

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<sup>46</sup> Optus Submission, paragraph 6.21.

<sup>47</sup> CCC Submission, page 40.



fact outside the Commission's powers) for the Commission to deem prices post 2005/06 as part of its review of these Undertakings.

- 68 Furthermore, the proposal by Gibson Quai that the Commission find at the end of the five-year regulatory period currently being considered that there are no further ULLS specific costs, is counter-intuitive and entirely unsupported and should be rejected out of hand. Contrary to this claim, at the end of the five-year regulatory cycle, Telstra might incur additional capital costs to maintain and replace the depreciated capital base and to improve the system for the benefit of access seekers. There will also be some capital that has not been fully depreciated by the end of 2005/06. Accordingly, Telstra will continue to incur depreciation and capital costs. It is reasonable for Telstra to recover these costs, in addition to any O&M costs, post 2005/06. Absent analysis pertaining to the future period, Gibson Quai's proposal that the Commission make such a finding is inappropriate.
- 69 Gibson Quai's proposal is tantamount to arguing that once Telstra invests in capital equipment to supply as service, it should not be able to recover costs in subsequent periods of any additional capital investment even though this additional capital equipment is delivering benefits in those subsequent periods.
- 70 Gibson Quai's proposal that the Commission make such a determination would require additional information and modeling not yet undertaken by Telstra. In addition, Gibson Quai's proposal would be impossible to implement on a factual basis and, therefore, is not appropriate.

### LSS

- 71 Gibson Quai claims that the Telstra model seeks to annualise the once off capital costs associated with the development of the IT systems over a four-year period where it had previously applied a five year period in order to align the return period with the end date of the undertaking.<sup>48</sup> Gibson Quai claims that if Telstra had assumed previously that the LSS specific capital investment life was five years, then if the Commission were to accept Telstra's LSS Monthly Charges Undertaking the contribution to the capital cost of the Telstra system included in the cost of LSS in 2007/2008 would be zero. This is incorrect. At the end of the five-year regulatory period, Telstra might incur additional capital costs to maintain and replace the depreciated capital base and to improve the system for the benefit of access seekers. There will also be some capital that has not been fully depreciated by the end of 2005/06. Therefore, Telstra will continue to incur depreciation

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<sup>48</sup> CCC Submission, page 35.

and capital costs and it is reasonable for Telstra to recover these costs, in addition to any O&M costs, post 2005/06.

- 72 Gibson Quai confuses the annualisation period with the period over which Telstra has “smoothed” the recovery amount. Telstra continues to annualise the capital costs over five years in line with previous Undertakings.
- 73 Gibson Quai states that a period of seven to ten years is more appropriate for Telstra’s operational systems but provides no good reason why the asset life should be determined by the period of the undertaking.<sup>49</sup> In response, Telstra notes that it does not determine the asset life of capital by the period of the Undertakings. The asset life used in the modelling is determined by the useful life of the assets being costed. The asset life was proposed by Telstra and generally agreed to by industry in earlier consultations.<sup>50</sup>

### **Appropriate Method of Cost Recovery**

74 In its ULLS Discussion Paper, the Commission asked for submissions on the appropriate method of recovery of ULLS specific costs. In particular, the Commission asked for submissions on:

- (a) the services over which ULLS specific costs should be recovered;
- (b) how historical costs and revenues should be treated; and
- (c) whether ULLS specific costs should be recovered through monthly fees, upfront fees or some alternative method.

75 In its LSS Discussion Paper, the Commission asked for submissions on Telstra’s cost modelling of LSS specific costs, particularly with respect to adopting a cost recovery period of years and using average through year demand numbers.

76 Telstra responds to the Access Seeker submissions on these issues below.

### **General**

77 Optus claims that when considering Telstra’s Undertakings the Commission should be scrutinising the cost recovery methods employed by Telstra and asking the question whether certain costs could be recovered in an alternative way that would still enable cost

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<sup>49</sup> CCC Submission, page 35.

<sup>50</sup> The Communications and Media Policy Institute University of Canberra and AAS Consulting, *Review of Telstra’s ULLS-Specific Costs: Draft Report*. See specifically page 6, where the authors claim: “our discussions with Access Seekers as part of this review indicated support for an assumed 5-year project period”.

recovery by Telstra, yet keep prices as low as possible to encourage uptake of the service.<sup>51</sup>

78 While Telstra agrees with Optus that cost recovery must be ensured, it strongly disagrees that in selecting the appropriate cost recovery approach the choice should be driven by seeking the lowest prices possible (whether the reason given for such an approach is to encourage uptake of the service, or to maximise entry or access-seeker profits). Rather, the cost recovery approach selected should be that which promotes the LTIE by maximizing economic efficiency. Efficient prices do not encourage low prices, entry or service take up for their own sake, but rather:

- (a) necessitate cost recovery (as accepted by Optus); and
- (b) signal the resource cost of the service to potential buyers, thereby ensuring purchases occur only when the buyer values the service as much as it costs to produce the service.

79 ULLS specific costs are directly attributable to the supply of ULLS and would not be incurred except for ULLS supply. Any competitive firm would incur these costs if it provided ULLS to its rivals, and would only offer a ULLS service if the market price is, at least, expected to cover the ULLS specific costs. For example, Optus (which has a large local loop network of its own),<sup>52</sup> would not (and currently does not) offer unbundled access to third parties if it were unable to recover the kinds of ULLS specific costs that it would incur. This is what Telstra currently faces under mandatory unbundling.

#### Services across which specific costs should be recovered

80 The comments in paragraphs 83 to 95 below apply equally to the recovery of ULLS and LSS specific costs.

81 Optus argues that the appropriate cost recovery method for ULLS specific costs is to recover these costs over all fixed lines, not just ULLSs purchased by Access Seekers.<sup>53</sup> Optus raises a number of arguments in this respect.

82 Similar to the Commission's position in its Draft Decision, Optus argues that ULLS is a service allowing all lines to move between Telstra and Access Seekers and that ULLS

<sup>51</sup> Optus Submission, paragraph 1.6.

<sup>52</sup> Optus has a local loop network delivered over HFC in metropolitan areas and fibre in CBD areas, passing 1.4m homes and connecting over 14,000 CBD buildings. See presentation by Bill Hope, *Singtel Networks*, June 2005.

<sup>53</sup> Optus Submission, paragraph 2.1.

specific costs are incurred as a result of the service declaration (which has resulted from the fact that the local loops display strong monopoly characteristics) and the need to establish a workable wholesale market for the service. Optus' second ground is that the costs associated with the ULLS are essentially the costs associated with correcting a natural monopoly market failure and should be borne by all users of fixed line telephony services.<sup>54</sup>

- 83 Telstra rejects this claim. Academic research has shown that the cost function for the supply of the bulk of local loops in Australia does *not* exhibit natural monopoly characteristics.<sup>55</sup> In addition, market outcomes show that local loops are competitively supplied - with Optus, TransACT, Unwired, iBurst and other HFC cable and wireless companies competing against Telstra's local loop. Accordingly, any claims of natural monopoly are invalid. Even if this evidence were ignored and it is assumed that there is a natural monopoly for the supply of local access (which there is not), Part XIC of the TPA dictates that end users should face the full (efficient) resource cost of access services. Therefore, the pricing approach for ULLS should be consistent with the statutory criteria and should not be based on Optus' philosophical considerations of public policy funding.
- 84 In response to the argument that the service declaration was intended to benefit all end users (regardless of whether or not they use ULLS) and so the costs associated with the declaration should be recovered over all lines,<sup>56</sup> Telstra refers to its discussion in section C of the main submission and Annexure B (and all of its previous submissions on this issue).<sup>57</sup>
- 85 It is disingenuous (and self-serving) of Optus to argue that a USO-type funding arrangement should be implemented for ULLS (when no supporting policy framework for this approach exists) simply because this would lower its costs of using the access service, while at the same time arguing that it should not contribute to the USO even though there is a clear policy framework for industry as a whole to fund universal service.
- 86 It is also disingenuous (and self-serving) of Optus, and contrary to the LTIE, to argue that costs specifically attributable to ULLS and LSS, which primarily benefit access-seekers

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<sup>54</sup> Optus Submission, paragraph 2.1.

<sup>55</sup> See, for example, Bloch, H. et al (2001), "The Cost Structure of Australian Telecommunications", *The Economic Record*, Vol. 77(239), December 2001, pp. 338-350.

<sup>56</sup> Optus Submission, paragraph 2.5.

<sup>57</sup> See, for example, Henry Ergas' *Expert Report on Recovery of ULLS-specific Costs* submitted in support of Telstra's Response to the ULLS Discussion Paper.

(prominently Optus) and their customers, should be paid for by third parties who receive no, or almost no, benefits from ULLS or LSS-based services.<sup>58</sup>

87 The single largest beneficiary of the ULLS subsidy proposed by Optus, and ultimately its foreign-based owners, is Optus itself and, as a group, access seekers. If other users subsidise ULLS specific costs, as will happen if ULLS specific costs are recovered over a broad range of services, then the resulting (subsidized) profits Optus earns by supplying services over ULLS or LSS will simply be repatriated to Optus' Singaporean owners. This in no way benefits Australian consumers (end-users), whether those consumers purchase ULLS or LSS-based services from Optus, or purchase a service that competes with Optus' ULLS or LSS-based services.

88 Optus' suggestion that ULLS services result in benefits to users who do not purchase services from Optus or other access-seekers is tenuous at best. Optus does not explain how such customers would benefit, but the only plausible explanation is that ULLS-based supply will lead to market-wide cuts in quality-adjusted prices. This hinges on two factors:

- (a) the degree to which the price of ULLS-based services will undercut the prevailing market price; and
- (b) the extent to which this will flow through to general prices.

89 Optus provides no indication in its submission that it intends to cut prices once it builds its ULLS network. However, even if Optus does cut the (quality-adjusted) price of ULLS or LSS-based services (and it may not - for example, actual price cuts may simply reflect a lower quality service), market forces will only partially transfer such price cuts to other carriers because of horizontal product differentiation.<sup>59</sup> Moreover, in the time frame under consideration, a wide range of customers, well beyond those in rural regions, will not benefit at all from ULLS because they will not be offered ULLS-based services. Optus has no claim to a subsidy generally and, in particular, from these customers.

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<sup>58</sup> For example, Telstra's rural customers who are unlikely ever to see any investment from Optus. Indeed, this is also true of those Telstra customers who Optus will not offer service to in the time period under consideration.

<sup>59</sup> Horizontal product differentiation implies different customers see different suppliers as providing different levels of quality.

- 90 In summary, Optus' argument that all benefit, and so all should *equally* pay for ULLS, completely ignores the fact that only some parties benefit from ULLS and by different magnitudes. In fact, Optus is likely to be the chief beneficiary of such a subsidy, while the bulk of customers will gain little, if anything. It also completely ignores the LTIE objectives of Part XIC of the TPA, which would not be served by a subsidy that distorted economic choice and investment while inflating the profits of a foreign-owned entity.
- 91 Optus raises the argument that competitive neutrality issues would dictate that Telstra should fund a portion of the ULLS specific costs to remove a competitive advantage Telstra would otherwise gain over access seekers. Macquarie also submits that it is appropriate for ULLS specific costs to be levied on access seekers in order to ensure competitive neutrality and argues that they should be recovered across all services that are equivalent to ULLS (including Telstra supplied lines, LSS, and DSL (both wholesale and retail)).
- 92 As noted in section C of Telstra's Submission and in Annexure B, Telstra submits that ULLS and LSS specific costs should be recovered from ULLS and LSS prices, respectively. To recover these costs over a broader range of services would reduce productive, allocative and dynamic efficiency and would be inconsistent with the LTIE.
- 93 Not only is it unreasonable for Optus and Macquarie to seek such a subsidy from other ADSL customers (as has been argued above), but, contrary to their claims, forcing ADSL customers who do not use the ULLS declared service to subsidize ULLS access seekers is not consistent with either short- or long-run competitive neutrality. This is discussed in more detail in Annexure B.

#### Treatment of historical costs and revenues

- 94 Optus claims that the appropriate cost recovery period for the ULLCIS is over 10 years.<sup>60</sup> Telstra submits that a five year asset life is appropriate and is consistent with previous regulatory decisions relating to ULLS.<sup>61</sup> Furthermore, the asset life should not be determined, as Optus suggests, on the basis that "*a longer period for cost recovery would mean that costs on a per unit basis of the service would be lower*".<sup>62</sup> Regulatory pricing on this basis would simply increase the profitability of Optus but would be inconsistent with the LTIE. Rather, the asset life should be determined according to economic principles, having regard to the physical and technological obsolescence of the relevant assets.

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<sup>60</sup> Optus Submission, paragraph 6.4.

- 95 Optus alleges that Telstra has now altered its costing methodology so that the 2005/06 prices reflect costs that were incurred six years previously.<sup>63</sup> Optus claims that the six year levelisation period adopted by Telstra in its ULLS Monthly Charges Undertaking has the effect of backloading costs incurred in earlier years (1999/00) to later years (2005/06).<sup>64</sup> This is correct. Telstra's initial cost modelling, however, did not backload costs as much as was necessary given that the large demand forecasts estimated by the Commission have not been realised (see paragraphs 101 to 102 below).
- 96 Gibson Quai says it agrees with the Commission's position that if Telstra were allowed to recover any losses incurred in the first four years of ULLS then this removes any risk from the provision of ULLS. Further, Gibson Quai alleges that the removal of any risk is not in the interest of the end users because without risk Telstra will not be encouraged to provide ULLS in an efficient way, which will affect ULLS access seekers and end users in the long run.
- 97 Gibson Quai notes that the work carried out by the Commission in relation to the *Pricing of unconditioned local loop services (ULLS) Final Report March 2002* sets a precedent that the period for recovery of capital expenditure associated with this service should be a five year forward looking period.<sup>65</sup> Telstra agrees that the period of annualizing fixed costs is indeed five years. Gibson Quai appears to be confusing the period of time over which Telstra has "smoothed" the recovery amount and the period over which fixed costs are annualised.
- 98 Gibson Quai might be concerned that the levelisation of annualised costs<sup>66</sup> means that costs incurred in 2005/06 are recovered from demand in earlier years, or costs are frontloaded. However, this is simply not true. Given the temporal structure of ULLS specific costs (high upfront costs with lower on-going costs), the levelised price in 2005/06 is likely to be higher than the annualised cost, so that prices in 2005/06 recover all annualised costs in 2005/06 plus some backloaded costs from earlier years. Thus, Gibson Quai's claim that annualised costs in 2005/06 are recovered from demand in earlier years is not true.

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<sup>61</sup> As acknowledged by Optus in paragraph 6.5 of its submission.

<sup>62</sup> Optus Submission, paragraph 6.4.

<sup>63</sup> Optus Submission, paragraph 6.7.

<sup>64</sup> Optus Submission, paragraph 6.7.

<sup>65</sup> CCC Submission, page 39.

<sup>66</sup> Annualised costs are the costs for each year derived as the sum of relevant O&M costs incurred in that year, economic depreciation that falls due in that year and the average year depreciated value of relevant assets multiplied by the WACC. "Levelisation" refers to the process whereby these annualised costs are smoothed over

- 99 In October 2003, the Commission determined model price terms and conditions for ULLS that were based on a TSRLIC model that backloaded costs from earlier years in the project's life to later years.<sup>67</sup> As part of this, the Commission backloaded Telstra's costs by forecasting high levels of demand,<sup>68</sup> despite Telstra's insistence that the forecasts were overestimates.<sup>69</sup> The fact that these large demand forecasts were not met meant that costs were further backloaded than originally intended (since actual cost recovery in the early years was lower than forecast).
- 100 Since the Commission's initial demand forecasts have not eventuated, Telstra has not been able to recover the backloaded costs. In the current ULLS Monthly Charges Undertaking, Telstra has chosen a levelisation period of six years to allow Telstra the opportunity to recover these previously backloaded (but unrecovered) costs while having a stable price over the Undertaking period. In short, Telstra is not recovering losses from previous years. Rather, Telstra is seeking to recover ULLS specific costs that were backloaded from previous years in accordance with the Commission's earlier ULLS specific cost decisions.
- 101 Furthermore, preventing Telstra from recovering these backloaded costs would be contrary to sensible regulatory policy and, given the effect this will have on incentives to invest in infrastructure, would not be in the LTIE. The Commission has, on many occasions, suggested that Telstra should backload its ULLS specific costs.<sup>70</sup> Preventing Telstra from recovering these backloaded costs would be a pure regulatory taking. It would also reduce the incentive for any potentially regulated firm (particularly those building ULLS networks with the intention of providing voice services) and investors in other industries regulated by the Commission to backload upfront costs as they might expect the Commission to prevent them from recovering their backloaded costs in future years.

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time to give a steady price that exactly recovers the (discounted) amount of these costs over forecast demand volumes.

<sup>67</sup> ACCC 2003, Final Determination for Model Price Terms and Conditions of the PSTN, ULLS and LCS Services, October.

<sup>68</sup> Backloading occurs when prices are based on levelised costs and demand is rising. Under those circumstances, a higher proportion of total annualised costs are recovered in the future, when demand is higher.

<sup>69</sup> For example, the Commission forecast demand at 31 June 2004 to be 53,000 when demand actually was 24,623, less than half of this.

<sup>70</sup> For example, in ACCC (2003), *Final Determination for the Model Price Terms and Conditions of the PSTN, ULLS and LCS Services*, October 2003, the Commission created demand forecasts that "seek to balance the need to stimulate ULLS take-up through lower ULLS prices" (at page 83). Also, in ACCC (2004), *Assessment of Telstra's Undertaking for PSTN, ULLS, and LCS: Draft Decision*, October 2004, the Commission proposed a ULLS pricing approach that allows "more of the initial ULLS-specific costs to be recovered by future demand" (at page 41).



- 102 Telstra rejects Optus' claim that Telstra is unlikely to have made a loss on the ULLS service if it had recovered the costs from other services.<sup>71</sup> If Telstra makes a loss on ULLS and taxes the profits from its other services to recover this loss, then this does not mean that the ULLS losses simply disappear. It merely means they are recovered by a distortionary tax on services unrelated to ULLS. It would also result in Telstra's retail and other wholesale customers subsidising ULLS access seekers' costs, which is economically inefficient as discussed above.
- 103 Gibson Quai's suggestion that "*without risk Telstra will not be encouraged to provide ULLS in an efficient way*"<sup>72</sup> is ludicrous. Even if Telstra faced no risk, Telstra would face strong incentives to supply services at the lowest possible cost.
- 104 Macquarie argues that it is unreasonable for Telstra to attempt to immediately recover from the 2004/05 and 2005/06 prices all costs associated with the provision of ULLSs and that these costs should necessarily be backloaded in order to ensure that demand is not artificially suppressed.<sup>73</sup> Macquarie considers that those capital costs that are deemed to be recoverable should be annualised using a tilted annuity formula that is tilted in favour of access seekers so that the capital expenditure is recovered in the longer term as the ULLS user base increases.<sup>74</sup>
- 105 As noted above, Telstra submits that ULLS specific capital costs have already been substantially backloaded. This has been achieved by levelising the ULLS specific costs over a six-year period. Figure 2, at paragraph 62 above, illustrates this. For example, although the majority of capital associated with the ULLS service was invested by Telstra before 30 June 2001,<sup>75</sup> the majority of costs associated with this capital will be recovered from demand well after this date.
- 106 Telstra submits that it is unreasonable to further backload the recovery of its ULLS specific costs. Further backloading cost recovery will increase the risk that Telstra will not recover these costs at all. What Macquarie proposes is that prices be set to guarantee profits to access-seekers (such as itself) without regard to Telstra's commercial interests. This would create particularly perverse investment incentives, since even absent such favourable pricing, asset-seekers bear, relative to Telstra, trivial risks in terms of their

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<sup>71</sup> Optus Submission, paragraph 6.8.

<sup>72</sup> CCC Submission, page 39.

<sup>73</sup> Macquarie Submission, page 7.

<sup>74</sup> Macquarie Submission, page 7.

<sup>75</sup> For example, Telstra's capital expenditure in 1999/00 and 2000/01 is \$ "c-i-c" and \$ "c-i-c", respectively. Telstra's capital expenditure in 2001/02 was \$ "c-i-c" and actual and planned capital expenditure in later years sums to \$ "c-i-c" in nominal terms.

infrastructure investment. Backloading cost recovery would punish Telstra for making such investments, while rewarding access seekers for not making such investments. This is particularly the case if, prior to Telstra recovering the further backloaded costs, it is determined that Telstra must recover those backloaded costs from its own ADSL customers, as has been suggested by Macquarie. Such a policy is hardly likely to elicit future investment in infrastructure, most notably from access seekers, but also from Telstra.

- 107 As noted above, Telstra has provided capital for ULLS, built the ULL service, and actively provides the ULLS to access seekers. It has also played a crucial role in introducing DSL to the general public, which benefits all DSL suppliers. It is now time for access seekers, including Macquarie, to pay for the costs of ULLS since they are now benefiting from its availability.
- 108 Optus claims that it would still be inappropriate to allow Telstra to recover its costs as proposed on the basis that Telstra's conduct has hindered the uptake of DSL services (and therefore uptake by access seekers of the ULL service), and that Telstra is largely to blame for some, if not all of the losses it has made. Optus alleges that Telstra's specific conduct has included:
- (a) monopoly pricing of DSL services prior to the introduction of competition in the market;
  - (b) the creation of delays and uncertainty about pricing of DSL access services, including ULL and wholesale DSL; and
  - (c) problems with Telstra's initial DSL services.<sup>76</sup>
- 109 Telstra rejects the claim that it has hindered ADSL take-up in Australia. Optus' accusation has no standing in fact. The Commission has recently reported the third consecutive quarter of ADSL growth over 20% and the 11<sup>th</sup> consecutive quarter (all quarters listed in the Commission's report) of ADSL growth over 10%.<sup>77</sup> From the end of 2002 to June 2004, Australia was the fifth fastest broadband growing OECD economy with more than 60,000 broadband services.<sup>78</sup> Furthermore, at June 2004, competitive

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<sup>76</sup> Optus Submission, paragraph 6.9.

<sup>77</sup> ACCC (2005), Snapshot of Broadband Deployment as at 31 March 2005.

<sup>78</sup> NECG (2004), "Broadband Penetration in OECD and EU Countries: Dispelling the Myths", October 2004, [http://www.necg.com.au/pappub/broadband\\_necg\\_report\\_oct2004.ppt](http://www.necg.com.au/pappub/broadband_necg_report_oct2004.ppt).

ISPs in Australia had a higher combined share of ADSL subscribers than any of the 15 European countries compared in a recent study.<sup>79</sup>

- 110 It is incorrect for Optus to characterise Telstra's pricing of DSL prior to Optus entry into DSL as monopolistic. Prior to launching its own DSL services in January 2004, Optus competed against Telstra's DSL with its cable modem services.<sup>80</sup> Other wireless (Unwired, iBurst etc) and cable networks (TransACT etc) also competed against Telstra wholesale. In addition, at the end of 2004 many other DSL access seekers were competing against Telstra's retail services.
- 111 Telstra also rejects Optus' claim that Telstra created delays and uncertainty in relation to the pricing of DSL services. Telstra notes that from July 2003, approximately six months prior to Optus launching DSL services, there were over sixty ISPs who had successfully negotiated agreements with Telstra to purchase wholesale DSL. Additionally, to the extent that ULLS price uncertainty exists, it has clearly not prevented iiNet and Primus from deploying their DSL networks using ULLS. Together they have rolled out to a substantial number of exchanges.<sup>81</sup> The fact that other ISPs have beaten Optus to the market for ADSL and ULLS indicates that uncertainty does not explain Optus' delay, but is more likely due to regulatory gaming and/or cumbersome internal decision-making on behalf of Optus.
- 112 Telstra notes that such teething difficulties are common with new services, especially ones using entirely new technologies supplied over a complex and existing network. Telstra is also pleased to offer its ADSL customers service level guarantees to help customers meet the cost of their bills when unplanned outages do occur.
- 113 Optus claims that it is reasonable to expect Telstra to share with access seekers the risks associated with ULLS.<sup>82</sup> Telstra's ULLS Monthly Charges Undertaking does exactly this - although with any backloading of costs Telstra bears more risk than access-seekers (because there is a chance that Telstra will never recover the costs it has incurred).

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<sup>79</sup> NECG (2004), "Broadband Penetration in OECD and EU Countries: Dispelling the Myths", October 2004, [http://www.necg.com.au/pappub/broadband\\_necg\\_report\\_oct2004.ppt](http://www.necg.com.au/pappub/broadband_necg_report_oct2004.ppt).

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<http://www.optus.com.au/portal/site/WOCA/menuitem.6d6045a9259bfcca9b2e6decc00345a0/?vgnextoid=e0cae8497e8bef00VgnVCM10000029a67c0aRCRD&vgnnextchannel=0b3cb5831cf2cf00VgnVCM1000006801540aR CRD&cpsextcurrchannel=1>

<sup>81</sup> For example, iiNet has announced it plans to rollout to an additional 111 exchanges which will bring the total number of exchanges to over 200 by the end of 2005 - [http://www.iinet.com.au/news/dslam\\_expansion.pdf](http://www.iinet.com.au/news/dslam_expansion.pdf).

<sup>82</sup> Optus Submission, paragraph 6.10.

- 114 Telstra's preference has always been to minimise volume risks by basing prices on realistic demand forecasts. However, the Commission mandated the use of unrealistically high demand forecasts, imposing a high level of volume risk on Telstra. It is this high level of regulator-mandated risk that Telstra is seeking to share with industry by backloading costs, not normal commercial risks that can be managed in the usual fashion. Besides, the comparison with risk management in an unfettered commercial environment alluded to by Optus does not exist for ULLS, given the magnitude of regulatory intervention.
- 115 Telstra's ULLS Monthly Charges Undertaking reduces the risk for access seekers *and* Telstra, by ensuring that ULLS prices are not dependent on uncertain demand forecasts beyond 2005/06. If the period of levelisation were extended beyond 2005/06, this would increase the risk of cost over-recovery *and* under-recovery symmetrically, as outlined in the *Expert Report on ULLS and SSS Specific Cost Models-Levelisation* submitted in support of Telstra's Response to the ULLS Discussion Paper.
- 116 Optus considers that in a competitive wholesale market, Telstra Wholesale, rather than its customers, would bear the risks of wholesaling. However, no such general statement can be made about risk bearing in a competitive market. It is true that competitive supply is only induced if expected demand can support prices sufficient to cover suppliers' expected costs, including compensation for risk bearing<sup>83</sup> (implying the ULLS price must compensate Telstra for any risks it bears). Yet, this in no way implies competitive suppliers always or even typically bear the risk of supply. The actual division of risk between demand and supply depends on the particulars of the situation, including the extent to which the differing parties are risk averse (or not) and on which parties can more efficiently reduce the risk of supply. It is also worth noting that in the present case the risk associated with ULLS provision is not a normal commercial risk. It is a risk that arises from a regulator setting access prices into the future based on uncertain demand forecasts beyond the Undertakings period (and in this case, the regulator's demand forecasts were not only overly optimistic, but were made despite Telstra's advice that they were overly optimistic).
- 117 It is also worth noting that Telstra's proposed approach more accurately mimics a competitive market than Optus'. In a normal commercial environment, if demand turned out to be lower than first expected, leading to an under-recovery of costs, suppliers would

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<sup>83</sup> Similarly, competitive supply cannot be sustained if, on an on-going basis, actual prices do not cover suppliers' costs including compensation for risk bearing.

have the opportunity to increase their prices to ensure cost recovery or to exit. Telstra's adjustment mechanism was designed to emulate this process.<sup>84</sup>

118 At paragraph 6.12 of the Optus Submission, Optus specifies a number of points that the Commission would need to consider at a minimum if it did make the decision to allow Telstra to recover past losses through future access prices. Telstra responds to these points below.

- (a) As discussed above, Telstra's model does not seek to pass through past losses to 2005/06. Rather, Telstra determines a price that just recovers the net present value of costs over the whole six year levelisation period. Therefore, there is no need for a mechanism to ensure that Telstra's Undertaking is not over-recovering past losses.
- (b) Telstra rejects Optus' unsupported opinion that Telstra overcharges for additional ULLS related services. In any case, they are not a part of the Undertakings that Telstra has submitted.

#### Recovery of costs from ongoing monthly charges versus once off charges

119 Optus submits that ULLS specific costs should be recovered in accordance with cost causation and that, in relation to monthly charges versus once off charges, economic theory would contend that all costs that are caused by the action of connecting a customer to the ULLS should be recovered as an upfront connection charge, while all ongoing costs should be reflected in the monthly access charge.<sup>85</sup> Telstra agrees with Optus that cost recovery should be tightly linked to cost causation. As a consequence, Telstra cannot understand how Optus can argue that ULLS users should not pay for ULLS specific costs.

120 Despite this, Optus is entirely mistaken in claiming that the *timing* of cost causation must be reflected in the timing of cost recovery. Consumers may make phone calls today, but it is perfectly efficient that they are not billed for them until the end of the month, and do not pay for them until the following month. Similarly, consumers can purchase cars in a competitive market, paying the dealer cash, or signing financing arrangements with the dealer to pay for them over the course of time. In both cases, consumers own the car and at the moment of the purchase should (and indeed do) pay the resource costs of producing

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<sup>84</sup> Exit, in this case, is not a likely option. It seems clear, sufficient numbers of individuals are willing to pay the cost of the service.

<sup>85</sup> Optus Submission, paragraph 3.2.

those cars,<sup>86</sup> and both means of payment are likely efficient. Indeed, the fact that a financing market emerges strongly implies that it would be inefficient to forbid financing.

- 121 In telecommunications, there are some instances where upfront costs are recovered from ongoing charges (consider mobile handsets even in highly competitive markets). This is often an efficient means of supply and can be normal commercial practice in other industries.
- 122 Therefore, although it might be efficient for connection charges to reflect connection costs in some cases, this is not necessarily true of all services. In some cases, it is normal commercial behaviour for ongoing costs to be recovered from upfront charges (for example, firms often recover the ongoing costs of providing warranties from the upfront sale price of goods and services).
- 123 Optus notes that it has concerns that Telstra's cost models attribute all of the costs associated with the ULLS connection centre to the ongoing monthly charge rather than the ULLS connection charge.<sup>87</sup> Telstra submits that:
- (a) it has correctly identified upfront and ongoing costs;
  - (b) the Undertakings appropriately recover these costs from upfront and ongoing charges; and
  - (c) the divisions between upfront and ongoing costs and revenues are reasonable.
- 124 If Optus' concerns here refer to the unmerited claim discussed above that upfront costs should only and always be recovered by upfront charges, then Telstra considers that Optus' concerns should be dismissed. Otherwise, what Optus is claiming is not clear to Telstra.
- 125 In its submission, Optus has pointed the Commission to the fact that Telstra charges access seekers a wide range of other once-off charge for performing various ULLS-related services and has said that it believes that the construct adopted by Telstra of charging access seekers for ULLS-related ad hoc services (as well as for ongoing monthly costs), is highly likely to result in double counting of costs.<sup>88</sup> Telstra rejects any suggestion that there is double counting between the prices set out in the ULLS Monthly Charges Undertaking and the once-off charge for performing ad hoc services. Telstra notes that

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<sup>86</sup> In a competitive market, the finance purchaser pays for both the cost of the car and the financing, but this does not change the fact that the purchaser does not pay for the car when it becomes his or hers, but rather pays for it over the course of the financing arrangement.

<sup>87</sup> Optus Submission, paragraph 3.4.

the Undertakings have never been intended to encompass all charges for the supply of the service, as is clear by the drafting of the Undertaking.

- 126 In response to Macquarie’s suggestion that there should be alternative payment options for ULLS specific costs,<sup>89</sup> Telstra submits that its ULLS Monthly Charges Undertaking does not prevent Macquarie from negotiating an alternative payment option for ULLS. Indeed, if Macquarie prefers to pay upfront, then it is free to pay the monthly charges for ULLS in advance. However, Telstra does not believe that it is necessary to include alternative payment options in the ULLS Monthly Charges Undertaking or that excluding alternatives makes the ULLS Monthly Charges Undertaking unreasonable. The ULLS Monthly Charges Undertaking, if accepted by the Commission, will provide a price benchmark for ULLS. Access seekers will be free to negotiate alternative price structures with Telstra around this price benchmark. In any case, given the vast range of possible pricing structures, it would be impractical to define them all ex-ante in the Undertaking.

#### **ACCESS DEFICIT CONTRIBUTION**

- 127 As noted in the Telstra Response to the ULLS Discussion Paper, Telstra relies on the expert report of Henry Ergas entitled “*Confidential expert report on access deficit*”, May 2005 as to the existence of the ADC and its recoverability as part of the prices for ULLS.
- 128 Some Access Seekers commented on Telstra’s inclusion of an ADC component as part of the monthly charges for ULLS. Telstra responds to these specific comments below.
- 129 Optus argues that from an economic efficiency perspective, the first-best option would be to price access services at cost (with the exception of where externalities exist) and states:

*“It is unclear whether Telstra’s pricing in different geographic [sic] is in fact lower than cost, particular [sic] when the total revenues of bundled services are considered.”<sup>90</sup>*

- 130 Further, Optus says that it does not see that the regulatory regime should facilitate Telstra’s commercial pricing strategy where there is no clear obligation driving Telstra’s existing retail price structures.<sup>91</sup>

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<sup>88</sup> Optus Submission, paragraph 3.5-3.6.

<sup>89</sup> Macquarie Submission, page 8.

<sup>90</sup> Optus Submission, paragraph 7.8.

<sup>91</sup> Optus Submission, paragraph 7.8.

131 Telstra agrees that PSTN access services should be able to be priced at cost, so long as this is understood to mean prices that recover costs. However, Telstra believes that to suggest that any pricing by Telstra for PSTN access services that might sit below the maximum Telstra could recover will inflate the ADC indicates that Optus does not understand how the ADC is calculated. However, this aside, Telstra suspects that Optus meant to say that the first-best option is to price access services at marginal cost, without any alternative mechanism for funding those costs. Such an approach is not “first-best” option. Rather, it is the worst option, as it would result in a supply failure of most large infrastructure projects including telecommunications.<sup>92</sup>

132 Optus also argues that the inclusion of an ADC component as part of the prices for ULLS could distort investment in potentially competitive markets, which would in turn harm the LTIE.<sup>93</sup> Telstra has previously addressed this incorrect argument in the expert report referred to in paragraph 129.

133 While Optus agrees in its submission with the other arguments raised by the Commission as to why it would not be appropriate to attribute an ADC component to the ULLS<sup>94</sup>, Optus provides no further evidence to support the Commission’s arguments. Telstra has already responded to these claims in the Telstra Response to the ULLS Discussion Paper.

## IEN COSTS

134 In its ULLS Discussion Paper, the Commission invited comments on the IEN costs which Telstra seeks to recover as part of the price for ULLS. As noted in the Telstra Response to the ULLS Discussion Paper, Telstra relies on the report of Henry Ergas entitled “*Confidential Expert Report on ULLS and SSS Prices - IEN Costs*” May 2005 (the “**IEN Report**”) in this regard.

135 Some Access Seekers made submissions on this issue. In particular, Optus makes a number of comments about the costs associated with providing sufficient IEN capacity to enable customers to switch back to Telstra and the foregone contribution towards that IEN

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<sup>92</sup> The classic, but Nirvana-like, first-best option involves an impossible poll tax, which theoretically generates no efficiency losses) to fund the service, plus marginal cost pricing. More practically, prices should be marked-up over marginal cost to the point at which the resultant distortions are equivalent to the distortions caused by general taxation, and any unrecovered costs should then be funding out of the government’s general budget. In Telstra’s case, even this option is not practical, and as a result, efficiency requires greater mark-ups over marginal cost. See, for the general case, Laffont, J.-J. and J. Tirole (1993). *A theory of incentives in procurement and regulation*. Cambridge, Mass., MIT Press; and specifically with respect to telecommunications, Laffont, J.-J. and J. Tirole (2000). *Competition in telecommunications*. Cambridge, Mass., MIT Press.

<sup>93</sup> Optus Submission, paragraph 7.9.

<sup>94</sup> Optus Submission, paragraph 7.10.



that would have been secured by Telstra had those customers not acquired services provided using the ULLS.<sup>95</sup>

136 AAPT argues that Telstra does not retain a level of IEN capacity for all future possible customers and so should not be compensated for lost traffic created by any other competitive investment.<sup>96</sup> Macquarie asserts that Telstra is claiming it is entitled to recover IEN costs from all Australian residents and disputes Telstra's arguments on the recovery of traffic-sensitive costs.<sup>97</sup>

137 Telstra responds to these submissions below.

**Costs associated with providing sufficient IEN capacity**

138 Optus states that it does not consider that Telstra incurs any costs in providing sufficient IEN capacity as the additional network capacity costs would be incurred by Telstra regardless of whether or not it was obliged to provide services to customers wanting to switch back to Telstra. Further, Optus argues that the appropriate test is whether Telstra would maintain less capacity in the IEN if it did not have a carrier of last resort (“COLR”) obligation.<sup>98</sup>

139 Telstra does hold excess IEN capacity directly as a result of its COLR obligation. If Telstra had no such obligation, or if another carrier such as Optus volunteered to take over the obligation, then Telstra would be able to achieve considerable savings in terms of forward looking long-run costs.

140 Optus says it is of the view that Telstra would not reduce the capacity of its existing IEN if it did not have the COLR obligation despite Telstra's evidence to the contrary. Moreover, Optus presents no evidence to support its assertion, and indeed cannot, as Telstra would not maintain a network capable of meeting a COLR obligation if this were not required. Telstra agrees with Optus that the “*appropriate question to be asking is whether Telstra would maintain less capacity in its IEN network if it did not face the COLR obligations*”<sup>99</sup> and confirms that the answer to that question is that Telstra would reduce the size of its IEN.

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<sup>95</sup> Optus Submission, paragraph 8.2.

<sup>96</sup> AAPT Submission, page 8.

<sup>97</sup> Macquarie Submission, page 10.

<sup>98</sup> Optus Submission at page 23.

<sup>99</sup> Optus Submission, page 23.

- 141 Optus claims that it would always lie firmly within Telstra's commercial interest to retain sufficient capacity in its IEN network to enable it to re-acquire customers that it has previously lost to competitors through ULLS. Optus' argument relates to customers that make a commercial decision to switch to Telstra rather than customers who are switching to Telstra as the COLR. The IEN costs claimed in relation to the COLR obligation are costs incurred over and above those incurred to meet anticipated growth, including normal growth relating to customers switching from Optus to Telstra, as explained by Telstra in the March Submission.
- 142 It is important to note there is a sharp difference between a commercial decision to be ready to capture switching customers, and an absolute legal obligation that is reinforced by a range of fines and potential regulatory actions. As with all commercial decisions, where it is simply a commercial decision Telstra would trade off the costs of maintaining extra capacity against the potential benefits of gaining a new customer. In particular, Telstra would not be willing to invest so as to be ready to meet all possible demand surges on the terms and conditions implied by the COLR. However, because of the COLR obligation, Telstra has no such luxury. Instead, Telstra must simply meet any demand for its services, and meet it within a regulated timeframe. This makes the calculus actually faced by Telstra very different to a mere commercial decision and (as has been well-recognised in a range of other regulated industries), the regulated supplier of a COLR obligation should be compensated for the necessary costs it must incur to meet that obligation.
- 143 As an aside, Telstra is pleased to see that Optus and Macquarie agree that it is prudent for Telstra to maintain excess capacity to take account of future growth in its user base. Telstra has attempted to recover the costs of prudently provisioning for future growth by including provisioning capacity in the PIE II model. However, Telstra notes that the Commission disagrees with the inclusion of provisioning capacity and has not allowed cost recovery for this capacity.<sup>100</sup> Despite this, the estimates of the IEN cost of the COLR obligation provided by Telstra are those costs Telstra incurs over and above its prudent provisioning for supplier growth.
- 144 Similarly, in relation to Optus' allegation that it is reasonable to posit that Telstra will seek to re-acquire the customers that switch to ULLS, and indeed that it will spend considerable amounts of money attempting to do so, Telstra again notes that Optus'

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<sup>100</sup> See Section C.2.1 of ACCC(2004), *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS: Final Decision*, December 2004.

argument relates to customers that make a commercial decision to switch to Telstra rather than those who are switching to Telstra as the COLR. Accordingly, for the same reasons detailed above Optus' argument is invalid.

- 145 Optus' claim that the IEN charge is not competitively neutral<sup>101</sup> is incorrect. It is not competitively neutral for Telstra to be the COLR without due recompense for this, while other competitors have no such obligation. Telstra's ULLS Monthly Charges Undertaking seeks to remedy this asymmetry and restore competitive neutrality by ensuring access seekers contribute to the costs of the COLR insurance that Telstra provides to ULLS-based access seekers' voice customers.
- 146 Optus also claims that it is not clear that the COLR obligations necessarily require Telstra to maintain capacity to provide services over its own network.<sup>102</sup> Telstra believes this claim, and the argument that it is highly unlikely that a significant number of customers would churn back to Telstra at any one time<sup>103</sup>, are irrelevant.
- 147 Given the size of the penalties faced by Telstra for breaches of its COLR obligation, as well as the obvious implications for its license and reputation, and Telstra's strong commitment to operate within the law at all times (independent of the consequences of breach), Telstra must and does maintain IEN capacity for all customers. However, Telstra believes that it is important to note that Telstra's approach to estimating the incremental cost of the IEN COLR capacity is highly conservative. That is, it leans toward an understatement of costs. However, even if this were not so, the impact of any overestimate of the IEN COLR capacity would only be marginally higher than the actual incremental cost due to the substantial economies of scale in the IEN.<sup>104</sup>
- 148 Optus' claim about fixed - mobile substitution and the argument that Telstra "*would be raising fixed line voice call prices to recover potential losses in revenue*"<sup>105</sup> if Telstra's ULLS line of argument were valid is incorrect. As Optus is well aware, Telstra faces retail price controls and competition that restrain Telstra's pricing of fixed voice call services. Given the fixed nature of Telstra's costs, there is no doubt that Telstra's average

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<sup>101</sup> Optus Submission, page 23.

<sup>102</sup> Optus Submission, page 23.

<sup>103</sup> Optus Submission, page 23.

<sup>104</sup> For example, the Commission estimates conveyance costs increase by 0.6% when the number of call minutes increase by 10% – see Section C.2.1 of ACCC (2004), *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS: Final Decision*, December 2004.

<sup>105</sup> Optus Submission, page 24.

IEN costs would increase if fewer total customers use the IEN. To say otherwise, which Optus appears to be doing, is incorrect.

### **Recovery of traffic sensitive costs**

- 149 Macquarie disputes Telstra’s right to recover traffic sensitive costs incurred in maintaining the IEN in order to comply with its COLR obligations and suggests that on the contrary Telstra should be paying access seekers for the costs they incur in maintaining the excess capacity of their networks in order to accommodate the future migration of Telstra’s end-users to their networks.<sup>106</sup>
- 150 As has already been stated, Telstra faces legislative obligations to act as a COLR and efficient resource allocation relies on the appropriate recovery of the costs of doing this from the parties that benefit. If Macquarie considers that the relevant legislative instruments are inappropriate, then it should seek to have them removed rather than seek to prevent Telstra from recovering its costs of complying with those instruments.
- 151 In relation to Macquarie’s alternative assumption that “*Telstra should be paying access seekers for the costs they incur in maintaining the excess capacity of their networks*”<sup>107</sup>, this would be true if alternative access seekers face and incur costs of COLR obligations. However, they do not. It follows that access seekers do not have COLR costs to recover from Telstra or any other provider. Telstra notes that neither Macquarie nor any other access seekers are volunteering to be a COLR.
- 152 Macquarie’s claim that the costs incurred in maintaining an IEN network as a result of maintaining excess capacity is not caused by access seekers taking the ULLS but by Telstra as a competitive provider ensuring that there is sufficient capacity for the possible future growth in its user base is incorrect. The IEN component of Telstra’s ULLS costs does not recover costs of maintaining “*sufficient capacity for the possible future growth in its user base*”.<sup>108</sup> The IEN costs claimed in relation to the COLR obligation are costs incurred over and above those incurred to meet anticipated growth, as carefully explained in Telstra’s original submission.
- 153 Macquarie also makes the strange suggestion that Telstra’s argument should be supported by evidence that it would be an “*economically rational response for Telstra to the*

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<sup>106</sup> Macquarie Submission, page 10.

<sup>107</sup> Macquarie Submission, page 10.

<sup>108</sup> Macquarie Submission, page 10.

*increase in competition... to begin dismantling parts of its IEN.”*<sup>109</sup> The reason Telstra proffers no such evidence is that it is not relevant. Telstra’s position is that the forward looking costs of the IEN when Telstra has a COLR obligation exceed the forward looking costs if Telstra has no such obligation - and that this difference should be supported in the ULLS access price.

**The foregone contribution towards that IEN that would have been secured by Telstra**

- 154 Optus argues that Telstra has no right to claim foregone revenues as a cost that should be reflected in the monthly charge for ULLS (on the basis that it is not reasonable to force ULLS customers to pay for a network that they are not using).<sup>110</sup> Optus is missing the key point in arguing its ULLS-based voice customers will not use Telstra’s IEN. As discussed in the IEN Report, an access seeker’s ULLS-based voice customers benefit and use the COLR *insurance* that Telstra is obliged to provide them which, like all insurance policies, provides utility whether or not it is actually called upon. Telstra’s IEN network is a component of this insurance.
- 155 According to Optus, it could be argued that customers that switch away from using Telstra’s IEN network have already partially compensated Telstra for the risk it faces of customers moving off its IEN network, thereby partially stranding the asset, through the WACC component of the wholesale services.<sup>111</sup> This argument is incorrect. The WACC component of wholesale services only compensates Telstra for non-diversifiable risks associated with the IEN network capital associated with capacity that is being actively used by access seekers. It does *not* compensate Telstra for capital costs associated with the excess capacity that Telstra must retain to satisfy its COLR obligations.
- 156 Again, Optus’ claim that Telstra’s proposed approach would raise serious competitive neutrality concerns is incorrect.<sup>112</sup> As noted above, it is not competitively neutral for Telstra to be the COLR without due recompense, while other competitors have no such obligation. Telstra’s ULLS Monthly Charges Undertaking seeks to remedy this asymmetry and restore competitive neutrality by ensuring access seekers contribute to the costs of the COLR insurance that Telstra provides to ULLS-based access seekers’ voice customers.

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<sup>109</sup> Macquarie Submission, page 10.

<sup>110</sup> Optus Submission, page 24.

<sup>111</sup> Optus Submission, page 24.

<sup>112</sup> Optus Submission, page 24.

- 157 AAPT claims that Telstra should not be compensated for lost traffic created by any other competitive investment.<sup>113</sup> Telstra is not seeking compensation for lost traffic, Telstra is seeking compensation for network investments that it must maintain to satisfy its COLR obligations. Since access seekers and their customers benefit from these investments, as set out in sections D1 and D2 of the IEN Report, it is efficient to recover these costs through LSS and ULLS prices to access seekers.
- 158 In any event, the PSTN services are not a competitive investment as AAPT claims. Telstra has USO and Customer Service Guarantees (“CSG”) that force Telstra to maintain the IEN into perpetuity even if Telstra has no customers on its PSTN network. A carrier operating in a competitive market would choose at some point to close down their IEN if there was likely to be insufficient demand in the future. Telstra does not have that option as its USO and CSGs require Telstra to be in a position to supply a working service within the designated timeframe.
- 159 AAPT argues that the main failure of Telstra’s argument for there to be an IEN contribution in the ULLS monthly charges is that Telstra ignores the opportunity created by ULLS to create new revenue sources from the IEN (for example, the connection of DSLAMs to the remainder of their network). Further, AAPT claims that:
- (a) there are significant scale efficiencies in transmission provision, so the “buy” option of using the Telstra IEN should be more attractive than the build option if Telstra correctly prices it; and
  - (b) as the ULLS customer is likely to be including voice and high-speed data requirements the transmission requirements will be greater than those Telstra faced from a PSTN customer alone.<sup>114</sup>
- 160 AAPT’s claim that “the ‘buy’ option of using the Telstra IEN should be more attractive than the build option”<sup>115</sup> is not correct. It is true that even when regulated prices appropriately reflect costs, then, at inefficiently small scales of entry, the buy option will (and should) be superior to the build option. However, on many routes entry occurs on a scale that makes building viable, as is demonstrated by competitive entry in markets the world over. For example, in Australia many alternative telecommunications service providers have built IEN networks. For example, Optus has an extensive network in

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<sup>113</sup> AAPT Submission, page 8.

<sup>114</sup> AAPT Submission, page 8.

<sup>115</sup> AAPT Submission, page 8.

metropolitan areas. Optus operates an extensive fibre network to backhaul Pay TV and HFC broadband traffic in Sydney, Melbourne and Brisbane.<sup>116</sup> Optus also operates fibre local access networks in most CBD areas in Australia. Network competition means that Telstra will not necessarily be the company that a ULLS-based access seeker will purchase IEN capacity from.

161 In addition, even if access seekers purchase IEN capacity from Telstra they are likely to take traffic off Telstra's network as soon as practical and carry it on their own backhaul networks. Therefore, access seekers might not send as much end-user traffic over Telstra's IEN as would be the case if the end user was a Telstra customer.

162 Telstra does not agree that its analysis ignores the revenue sources from other services. That is, in determining the transmission costs, Telstra takes into account the fact that the transmission network is used to provide other services apart from transmission for the PSTN. The economies of scope from using transmission to provide a range of services are captured in the price of transmission used in the PIE II model.

#### **Level of IEN capacity retained by Telstra**

163 AAPT states that Telstra does not retain a level of IEN capacity for all future possible customers.<sup>117</sup> In response to this, Telstra notes that its COLR obligation (which is outlined in detail in section C2.4 of the March Submission in support of Telstra's ULLS Monthly Charges Undertaking) relates to all end users of a standard telephony service.

164 As noted above in response to the claims made by Optus, given the size of the penalties faced by Telstra for breaches of its COLR obligation, as well as the obvious implications for its licence and reputation, and its strong commitment to at all times operate within the law (independent of the cost of breach), Telstra must and does maintain IEN capacity for all customers. AAPT should be aware that Telstra would incur substantial penalties, and the broader costs associated with a breach of its strong regulatory compliance record, if more demand shifted to Telstra than it had capacity to meet. In any case, Telstra is legally obligated to meet *any* demand shift irrespective of the penalties it faces for failing to do so. Consequently, Telstra has no choice but to have sufficient capacity on hand to meet all demand.

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<sup>116</sup> See SingTel Investor Day 28 June 2005 - Presentation by Bill Hope, EVP (Networks), [http://home.singtel.com/investor\\_relations/investor\\_presentations/default.asp](http://home.singtel.com/investor_relations/investor_presentations/default.asp).

<sup>117</sup> AAPT Submission, page 8.

165 However, even if it were the case (and it is not) that Telstra only invested in capacity capable of meeting realistically expected demand<sup>118</sup>, this would hardly change the necessary investment Telstra must make in capacity. There are two reasons for this. First, realistically expected demand amounts to a substantial demand shift. Telstra cannot, for example, consider the mean forecast of demand to be realistically expected demand. If more than the mean forecast of demand shifted to Telstra, which by definition has a 50% probability of occurring, then Telstra would have to breach its COLR obligation and incur substantial penalties. Indeed, investing in capacity necessary to cover demand shift events with a five percent probability over the long lifetime of IEN capacity would seem minimally prudent, given Telstra's legal obligations and the very high costs of failure to meet these. But this requires substantial investment in capacity. Secondly the economies of scale associated with the IEN implies that the incremental cost of adding a unit of capacity when building the network is small (though this is not necessarily the case when adding capacity to an existing network),<sup>119</sup> so the costs of overestimating capacity are much higher than underestimating capacity. Thus, prudence demands that Telstra hold capacity capable of meeting the largest possible shift in demand.

### **Entitlement to recover IEN costs from all Australian residents**

166 Macquarie is mistaken in arguing Telstra's position on IEN charges can be extended to the general Australian population.<sup>120</sup> As a COLR, Telstra supplies insurance to consumers who purchase services from ULLS access seekers, which in turn benefits ULLS access seekers. Access seekers can, for example, choose to offer service at cut-throat rates, without investing in reputation or making commitments to service quality or longevity, and their customers will know that if things do not work out they can quickly return to Telstra at minimum personal cost. It is Telstra's view that ULLS access-seekers, and ultimately their customers, should pay for this insurance.

167 It should also be noted that, while of course Telstra does not seek to recover its IEN costs from all Australian residents, Telstra currently recovers a proportion of its IEN costs from its own wholesale and retail telephony customers and would continue to do so under its Undertaking. Another proportion of Telstra's IEN costs must be incurred to satisfy

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<sup>118</sup> AAPT Submission, page 8.

<sup>119</sup> For example, the Commission estimates conveyance costs increase by 0.6% when the number of call minutes increase by 10% - see Section C.2.1 of ACCC (2004), *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS: Final Decision*, December 2004

<sup>120</sup> Macquarie Submission, page 9.



Telstra's COLR obligations. That is, to ensure access seekers' ULLS-based voice customers can return to Telstra's network in the event of a failure of the access seekers' networks businesses. Telstra seeks to recover the cost of providing this insurance from those that benefit from it - being access seekers and their ULLS-based voice customers.

168 Telstra does not agree that it is effectively asking access seekers to compensate Telstra for the movement of end-users from Telstra's network to their alternative networks irrespective of whether these alternative networks use the IEN.<sup>121</sup> Further, Macquarie errs when it states "the Macquarie Network will not utilise the IEN in any way".<sup>122</sup> While Macquarie might not send traffic over Telstra's IEN network, its customers benefit from the insurance of the COLR obligations, which require Telstra to hold spare capacity on the IEN. Macquarie indirectly benefits from the insurance and, therefore, should contribute toward its cost.

169 Finally, in relation to Macquarie's claim that Telstra's attempt to recover a portion of the IEN costs from ULLS access seekers is not reasonable<sup>123</sup>, Telstra believes it has explained in detail the reasons why it is reasonable for Telstra to charge this component of the ULLS costs from access seekers in the IEN Report. That report also shows that firms in other markets that must satisfy COLR obligations are entitled to recover their costs of doing so from customers.

## NETWORK COSTS

170 In relation to Telstra's calculation of its network costs, Optus says it remains of the view that there are fundamental problems with Telstra's PIE II model that have rendered its results unreliable, even with changes to the assumptions as made by the Commission.<sup>124</sup> Telstra understands that Optus is relying on previous submissions it has made on this point. In particular, Optus has confirmed that it was referring to the following:

- (a) Assessment of the PIE II model - a report prepared by NERA for Optus dated July 2003;
- (b) Optus' confidential submission to the Commission on "*Telstra's Undertaking for Domestic PSTN Originating and Terminating Access, Unconditioned Local Loop Service and Local Carriage Service*" - March 2004; and

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<sup>121</sup> Macquarie Submission, page 9.

<sup>122</sup> Macquarie Submission, page 9.

<sup>123</sup> Macquarie Submission, page 10.

<sup>124</sup> Optus Submission, page 10.

- (c) Comments on PSTN conveyance costs in PIE II - a report prepared by NERA for Optus dated March 2004.

171 In response to (a) and (c) above, Telstra refers to the expert report of Bridger Mitchell dated 29 September 2005. To the extent that the Commission considers or relies on (b) above, or any other Optus document referred to within those submissions, to ensure procedural fairness Telstra should be given an opportunity to respond to these documents in the context of the current undertakings.

172 Telstra also refers to Annexure D which responds to issues raised by the Commission on network costs.

**PUBLIC VERSION OF TELSTRA’S SUBMISSION IN RESPONSE TO  
THE AUSTRALIAN COMPETITION AND CONSUMER  
COMMISSION’S DRAFT DECISION ON TELSTRA’S ULLS AND LSS  
MONTHLY CHARGES UNDERTAKINGS**

**ANNEXURE F**

**RESPONSE TO ACCESS SEEKER SUBMISSIONS**

**Attachment A - Telstra response to AAPT review of sabotage literature**

- 1 In its submission, AAPT includes a review of economic literature on sabotage. Although AAPT has provided a review of the economic theory relating to sabotage<sup>125</sup>, it does not provide any evidence that this theory applies or has applied in ULLS, LSS or related markets. Rivals impose costs on Telstra when they are supplied with ULLS and LSS services. Telstra recovers these costs. This is not sabotage. It is cost recovery.
  
- 2 In addition, AAPT reviews the relevant ‘sabotage’ literature only selectively. For example, it does not mention the literature which shows ‘sabotage’ as being an unlikely strategy. For example:
  - (a) Most economic models of sabotage assume that the upstream market is supplied by a monopolist, and ignore upstream competition.<sup>126</sup> In the context of Telstra’s ULLS and LSS Monthly Charges Undertakings, the upstream markets are competitively supplied - Optus, TransACT, Unwired, iBurst and other HFC cable and wireless companies compete against Telstra’s ULLS and LSS services. Therefore, conclusions drawn from monopoly models are invalid in this context.

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<sup>125</sup> AAPT Submission, pages 9-16.

<sup>126</sup> Economides, N. (1998), “The Incentive for Non-Price Discrimination by an Input Monopolist”, *International Journal of Industrial Organisation*, Vol. (16) pp.271-284; Sibley, D.S. and Weisman, D.L. (1998), “Raising Rivals’ Costs: The Entry of an Upstream Monopolist into Downstream Markets”, *Information Economics and Policy*, Vol (10), pp. 451-270; Weisman, D.L. (1995) “Regulation and the Vertically Integrated Firm: The Case of RBOC Entry into Interlata Long Distance”, *Journal of Regulatory Economics*, Vol. (8), pp.249-266; and Weisman, D.L. (1999), “Vertical Integration and Exclusionary Behaviour in Network Industries”, Presented at the Rutgers University 12th Annual Western Conference, San Diego, California, 7-9 July. Further, BKM models a dominant firm/competitor fringe model, a construct which has been explicitly discounted by the Commission.

- (b) Sibley and Weisman show that if input prices are above marginal cost (Telstra's ULLS and LSS prices are likely to be above short-run marginal cost), then a vertically integrated firm might have incentives to lower rivals' costs.<sup>127</sup>
- (c) Mandy and Sappington state "*sabotage in practice is an empirical matter that merits investigation on an industry-by-industry basis*"<sup>128</sup>, yet no attempt is made by AAPT to empirically test whether sabotage is occurring.
- (d) Mandy and Sappington find that downstream product differentiation reduces the incentives to sabotage.
- (e) When analysing the US telecommunications market, MacAvoy, Weisman and Williams find that a Bell operating company ("**BOC**") would have to raise rivals' marginal costs by at least 72.3% in order to negate the welfare effects of BOCs entering the downstream market.<sup>129</sup>

3 AAPT also lists several conclusions from its literature review, each of which is incorrect as discussed below. The first conclusion is that Telstra has strong incentives to sabotage. This is based on several claims listed by AAPT. Each of these is considered.

- (a) *There is little downstream market product differentiation.*<sup>130</sup> In Telstra's view, this is incorrect. ULLS and LSS allow downstream firms to differentiate their services from Telstra's. For example, iiNet and Primus offer retail ADSL at speeds of up to 12mb/s, faster than Telstra's highest speed plan of 1.5mb/s. ISPs offer a variety of pricing options (e.g. charging for excess usage vs shaping download speeds) and bundles including other services (e.g. Optus offer ADSL pay TV, telephony and mobile bundles).
- (b) *There is a low cost of carrying out sabotage if the regulator allows Telstra to recover service-specific costs.*<sup>131</sup> Telstra considers this claim to be nothing short of bizarre. Telstra would in no way be engaging in sabotage if it recovered service specific costs. Instead, this is economically sound policy. Moreover, if AAPT merely fears that allowing Telstra to recover service specific costs would

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<sup>127</sup> Sibley, D.S. and Weisman, D.L. (1998), "Raising Rivals' Costs: The Entry of an Upstream Monopolist into Downstream Markets", *Information Economics and Policy*, Vol (10), pp. 451-470.

<sup>128</sup> Mandy, D.M. and Sappington, D.E.M. (2001), "Incentives for Sabotage in Vertically-Related Industries", mimeo April 2001, at page 2.

<sup>129</sup> MacAvoy, P.W., Weisman, D.L. and Williams, M.A. (2000), "Should Local Telephony Companies be Allowed to enter the Long Distance Market? A regulatory Conundrum", manuscript quoted in Mandy, D.M.

<sup>130</sup> AAPT Submission, page 17.

make it easier for Telstra to exaggerate such costs, then the appropriate response is not to ban recovery of service specific costs (which would be a case of the proverbial “throwing the baby out with the bath water”), but rather to ensure only real service specific costs are counted. But this is also irrelevant. In fact, the problem is not that service specific costs are overestimated, but quite the reverse. Telstra has been allowed to recover only a fraction of its ULLS specific costs.<sup>132</sup> Furthermore, the Commission and access seekers, including AAPT, have sought to exclude many of Telstra’s ULLS and LSS costs throughout the regulatory process. In short, if AAPT was to have its way, an even greater part of the legitimate costs Telstra has incurred to provide ULLS and LSS will not be recovered from access seekers.

- (c) *Telstra has superior efficiency in providing the service.*<sup>133</sup> Telstra agrees with AAPT that self-supply by Telstra of wholesale ADSL services is more efficient than the supply of wholesale ADSL to third parties (although this does not imply that Telstra is more efficient than its rivals in all aspects of retailing ADSL. For example, some its rivals may be more effective than Telstra in reaching a given market segment). However, Telstra also notes that, if it is overall more efficient than its rivals in retailing ADSL, and if access prices are correctly set, then Telstra would have no need for risky sabotage activities to out-perform its competitors in the market. Telstra also considers the LTIE are well-served if Telstra, because it has superior efficiency, can cut its quality-adjusted prices to a level that makes it hard for an inefficient rival to make profits. Moreover, such harm to competitors is not harm to competition. Finally, even if Telstra were to engage in sabotage (which, even if such actions were allowed, it would not do as a profit-maximising firm, and a good corporate citizen), then the welfare effects and the effects on the long-term interests of end users of inefficient firms exiting the market due to sabotage are not necessarily negative.
- (d) *There is little autonomy between Telstra’s upstream wholesale and downstream retail operations.*<sup>134</sup> Telstra rejects this claim. There is complete management autonomy at sub-CEO management levels, and this includes Telstra’s retail and

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<sup>131</sup> AAPT Submission, page 17.

<sup>132</sup> In its report *Final Determination for Model Price Terms and Conditions of the PSTN, ULLS and LCS Services*, the Commission relied on a report by external consultants that concluded Telstra should only recover 22 percent of the costs originally proposed by Telstra. The Commission accepted most of the external consultants’ recommendations, meaning that Telstra could not recover many of its ULLS specific costs.

<sup>133</sup> AAPT Submission, page 17.

wholesale ADSL businesses. Moreover, there are accounting separation regulatory mechanisms in place designed to ensure that the Commission can enforce equal treatment by Telstra of its retail arm and its retail rivals.

- (e) *There is little downstream competition.*<sup>135</sup> This is obviously incorrect. Downstream ADSL markets are extremely competitive, with many infrastructure-based competitors and hundreds of resale based competitors. AAPT suggests that the threshold market share for a vertically integrated telecommunications provider to engage in sabotage is 26%. However, this figure was calculated for a different country (the US), in a different market (local telephony), with different structural and regulatory characteristics, and is seven years old.
- (f) *There is little competition in the upstream market.*<sup>136</sup> This is incorrect. Optus, TransACT, Unwired, iBurst and other cable and wireless companies compete against Telstra's ULLS and LSS services. Moreover, it is not clear that the extent of upstream competition is relevant. Not only do a range of onerous regulations make sabotage of the type suggested virtually impossible (for example, accounting separation, below cost pricing, and the availability of a good substitutes, notably ULL, at regulated prices), but Telstra faces extremely high costs if a court were to find it engaged in such practices.
- (g) Since Telstra is subject to access regulation but less specific retail pricing regulation, Telstra has had a strong incentive to adopt a retail pricing approach in its business.<sup>137</sup> AAPT provides no explanation as to what a retail pricing approach is, how this would provide Telstra with incentives to 'sabotage' rivals, and what effect a retail pricing approach should have on the Commission's assessment of Telstra's Undertakings. AAPT further provides no substantiation of such (unexplained) behaviour.

- 4 AAPT's second claim arising from its literature review, is that the Commission would legitimise 'sabotage' if it allows Telstra to recover its ULLS and LSS specific costs.<sup>138</sup> As already noted, this claim is bizarre. AAPT could claim this about any of Telstra's costs (or any other party's costs for that matter). Economic efficiency requires that costs properly attributed to ULLS and LSS ought to be recovered by those who cause those

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<sup>134</sup> AAPT Submission, page 18.

<sup>135</sup> AAPT Submission, page 18.

<sup>136</sup> AAPT Submission, page 18.

<sup>137</sup> AAPT Submission, page 18.

costs to be incurred, in this case, access seekers. AAPT also claims that ULLS and LSS prices provide Telstra with compensation for a cost that it imposes on access seekers, that it does not impose on its own downstream business. This is also incorrect. BigPond must undergo similar (although not the same) process and procedures when provisioning ADSL.<sup>139</sup> BigPond recovers these costs through retail prices. If access seekers are exempted from compensating Telstra Wholesale for its LSS and ULLS specific costs, then they will have an artificial advantage over BigPond. AAPT also claims, but fails to substantiate, that, in certain circumstances, Telstra will receive compensation for inefficient investment in new technologies. Telstra does not consider this to be possible.

- 5 AAPT's third claim arising from its literature review is that even if ULLS and LSS costs are common CAN costs, then this is not likely to reduce Telstra's incentives to 'sabotage' rivals. Telstra explains above that it does not and has no incentive to engage in sabotage.
- 6 In conclusion, while the idea of access sabotage might have some emotional appeal in regulatory proceedings and public debates,<sup>140</sup> there has been no evidence proffered as to why Telstra would (if it could) engage in sabotage, or that Telstra has in fact engaged in such practices.

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<sup>138</sup> AAPT Submission, page 18.

<sup>139</sup> See, for example, Annexure B, paragraphs 48-60.

<sup>140</sup> The origins of the Australian dialogue on access sabotage appears to lie with the US academic Professor Paul Kleindorfer's appearance at the Commission annual Regulatory Conference in July 2004, and not with substantiated occurrences of such behaviour.