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Partner: Graham Phillips

Writer: Kimberley Lloyd - Senior Associate

Email: klloyd@herbertgeer.com.au

D 03 9641 8772

F 03 9670 5670

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Grahame O'Leary
Director
Communications Group
Australian Competition and Consumer Commission
GPO Box 3648
SYDNEY NSW 2001

By facsimile: (02) 9233 1092
By email: grahame.oleary@acc.gov.au

Dear Mr O'Leary

Submission in response to ACCC Discussion Paper reviewing pricing of the domestic transmission capacity service

1. INTRODUCTION

We welcome the opportunity to provide a written submission to the Australian Competition and Consumer Commission ('**ACCC**') on behalf of our client, iiNet. The purpose of this submission is to assist the ACCC in determining pricing principles for the Domestic Transmission Capacity Service ('**DTCS**') which it can apply in:

- setting up-front prices for all declared transmission services in an access determination under the regulatory regime proposed in the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009; or
- setting prices for transmission services for particular routes in a dispute pursuant to the current access regime under Part XIC of the *Trade Practices Act 1974*.

In preparing this submission, we have had regard to the ACCC discussion paper *Reviewing pricing of the domestic transmission capacity service*, dated April 2010, and a report by Frontier Economics entitled the *Economics of transmission capacity services*, dated June 2009.

We consider the key issues for access seekers raised in the inquiry relate to the aggregation of transmission services types for cost modelling; the price structures which are appropriate for recovering cost; and the asset valuation method for existing transmission assets. Accordingly, we have limited our submission to those aspects of the inquiry.

Melbourne Sydney Brisbane

Level 20/385 Bourke Street
Melbourne VIC 3000
GPO Box 524 Melbourne VIC 3001
Australia
DX 428 Melbourne

Telephone: +61 3 9670 6123
Facsimile: +613 9670 5670
www.herbertgeer.com.au
ABN 21 228 101 686

2. EXECUTIVE SUMMARY

iiNet's interests in the regulated transmission service primarily relate to the capital-regional transmission routes. However, to the extent assets used to provide other types of transmission (e.g. tail, inter-exchange, and inter-capital) are pooled together with capital-regional transmission, iiNet will have broader interests.

Accordingly, iiNet would support the following approach to determining DTCS access prices:

- less aggregation, and hence less averaging of costs, across different transmission services and transmission routes. This is because greater cost averaging would mean that (a) access seekers such as iiNet would be paying for costs associated with redundant paths that they do not necessarily make use of; and (b) access seekers of declared services would effectively be subsidising 'below average cost' pricing on highly competitive un-declared routes;
- regulatory prices being set on a point-to-point costing of transmission routes, rather than based on cost allocations modelled on interlocking (meshed) ring architecture;
- if assets are pooled and allocated:
 - iiNet opposes cost allocations based on competitive pricing or 'radial distance' as this will tend to allocate costs away from shorter, competitive routes to longer, uncompetitive routes (such as regional-capital); and
 - iiNet supports an equal allocation of costs to 'worker' and 'redundant' routes. Otherwise significant costs will be allocated to access seekers that do not acquire 'redundant' paths;
- price structures which give access seekers a fixed costs structure as far as possible. That is, upfront charges which reflect the costs of provisioning the bandwidth for the service (e.g. interface cards)¹ and on-going charges which maximise incentives to use the service, (i.e., not based on the bandwidth but based on characteristics of the service not associated with increased use); and
- prices being set at a level to achieve past cost recovery. This will encourage new investment by giving certainty that cost will be recovered. iiNet rejects the Frontier Economics argument that 'costing approaches that re-value' assets are necessary for efficient build/buy decisions. Such approaches are likely to create uncertainty and volatility in transmission prices without achieving the objective of discouraging inefficient bypass.

3. COMMERCIAL ARRANGEMENTS

We understand that the ACCC does not currently collect data on DTCS pricing and that the ACCC is therefore interested in obtaining information directly from

¹ with the flexibility to negotiate these as an on-going charge.

interested parties regarding the commercial arrangements which may affect regulatory price-setting.

In iiNet's experience, transmission prices vary according to a combination of the following factors:

- demand;
- available capacity;
- managed/shared v clear channel access;
- location of services and ability to interconnect services;
- quality of the network;
- technology/delivery protocol;
- additional capital expenditure required for delivery of the service;
- competitive alternatives;
- competitive intelligence;
- protection of existing revenues and scalability of the service; and
- price protection clauses in other customer contracts.

Transmission charges generally involve an upfront connection cost and a monthly recurring charge. Upfront connection charges vary depending on the length of the contractual term, with the longer the commitment the lower the up front charge. Price structures are largely the same for declared and non-declared services.

iiNet notes that, in most cases, where a supplier other than Telstra is present, commercially negotiated transmission charges are substantially lower for an equivalent or comparable service. iiNet also considers that other providers tend to add value in other ways which often result in the ability to offer the end user a better product.

Transmission products are typically purchased by iiNet as specific point-to-point links, rather than as part of a bundle. However, in some cases commitment to more than one service is required in order to secure the investment by the supplier to build the service.

For iiNet, where two or more suppliers are present, the availability of redundancy is not a critical factor in choosing a supplier for transmission services. On the contrary, if redundancy is required, iiNet prefers to source services from more than one supplier (i.e. a primary supplier and a secondary supplier) as this helps maintain competitive pressure on both parties.

Whilst iiNet requires geographical redundancy for inter-capital transmission, it is difficult to justify acquisition of redundancy for other categories of transmission. Redundancy is often presented as the preferred option of the supplier (to justify a

premium to be charged). However, suppliers will generally not commit to service level agreements and penalties to back up a fully redundant service. iiNet's operational preference is to manage redundancy itself by acquiring services and running services at a level of utilisation that corresponds with the operational risk associated with the services delivered to the customer.

4. **AGGREGATION OF TRANSMISSION SERVICES**

The regulated (declared) transmission services are predominantly:

- tail end services to individual customer premises (these are not acquired by iiNet);
- inter-exchange transmission in non-metropolitan areas (metropolitan interexchange is generally not declared); and
- regional-capital transmission (inter-capital transmission is not declared).

Telstra's transmission network is not disaggregated by regulated services and is based on interlocking (meshed) ring architecture providing all the regulated and unregulated transmission services mentioned above. Many assets are common to the provision of regulated and unregulated services. For example, some regional-capital transmission routes are 'spurs' or rings off inter-capital routes.

Telstra faces competition from other transmission owner's assets in areas where the service is not regulated (and more limited competition in some other areas). Interlocking (meshed) ring architecture allows Telstra to provide itself with a high level of redundancy, which is not necessarily acquired by access seekers such as iiNet.

The ACCC has indicated that it considers a "pricing mechanism that encourages investments in networks with ring structures to be desirable". The ACCC has also indicated that it is considering whether to aggregate assets/costs of transmission services with similar characteristics, i.e., terminating services (tail and inter-exchange transmission) and trunk (inter-capital and regional-capital) in determining upfront prices for transmission.

This creates risk for access seekers in that:

- modelling costs based on a ring architecture may result in prices which reflect the cost of redundancy which is not acquired by the access seeker; and
- allocations of cost across asset types (based on radial distance) may result in a greater share of fixed and common costs within the rings being allocated to longer uncompetitive routes from shorter, competitive routes.

We note that Telstra, in past submissions, has specifically supported cost modelling based on ring architecture and radial distance pricing (cost allocations).

In our view, access seekers have legitimate cause for concern regarding the modelling of costs based on providing a higher level of service (redundancy) acquired by Telstra, but not by access seekers. The solution to this may be a

requirement for redundancy to be provided by Telstra for the declared service if ring architecture is modelled. Alternatively, a mechanism could be adopted to discount services that are provided without redundancy.

In relation to the concern regarding the allocations/recovery of fixed and common costs from less competitive routes, we consider that prices on any point-to-point route should not be set above standalone costs. If fixed and common costs are loaded on to less competitive routes such that they are priced above standalone costs, this would encourage inefficient bypass.

5. PRICING STRUCTURES

DTCS charges are generally a combination of upfront and monthly charges, with upfront charges diminishing with long-term commitments. As discussed in section 3 above, transmission charges vary for a range of reasons and are not, in general, simply a function of distance or capacity. Nevertheless, in setting upfront charges for regulated transmission services the ACCC appears to be considering setting a menu of prices based on distance and capacity.

As we understand the cost structures of transmission services there are:

- large fixed (sunk) costs associated with trenching and laying fibre optic cable;
- fixed costs associated with provisioning (and separating) bandwidths across the fibre cable (e.g. interface cards, multiplexors); and
- low incremental costs associated with managing traffic on the network.

In addition, the interlocking (meshed) ring architecture of Telstra's network appears to magnify the extent of fixed and common costs amongst services.

Based on this cost structure, economic analysis leads us to conclude that 'efficient' prices should be set so as to recover the fixed costs of provisioning (or upgrading) bandwidth from access seekers seeking those services, and hence causing those costs to be incurred.² Otherwise, 'efficient' charges for services should be set very low, to recover incremental cost and not discourage use of excess capacity on the network.

However, in order to ensure cost recovery of trenching and fibre cost, charges will need to exceed incremental costs by a significant degree. From an efficiency perspective it is important that such charges do not discourage use of the network if it is uncongested.³ Apart from that, we consider the main criteria for recovering fixed and common costs should be:

- to create least efficiency distortions, in particular, to avoid inefficient bypass; and

² Perhaps in the form of upfront charges or monthly charges over the term of the life of the underlying assets.

³ This should be the case if service provisioning costs are covering the cost of bandwidth upgrades.

- to minimise distortions to competition where Telstra is vertically integrated into downstream services.

In regard to inefficient bypass, Telstra would likely have an incentive on its own to avoid bypass. That is, it would have an incentive to price transmission on potentially competitive routes low. This does, however, mean that in order to achieve cost recovery, Telstra would need to price higher on less competitive routes. This price structure appears to be what is being 'proxied' by the radial distance pricing menu.

In our opinion it is incorrect of Frontier Economics to indicate that distance/bandwidth pricing is necessary to reflect cost causation. This gives this pricing structure economic legitimacy that it does not deserve. As noted above, in our view it would in fact be economically inefficient to recover fixed costs from bandwidth charges if there is excess capacity on the network.

Moreover, recognising that we are simply talking about fixed cost recovery, access seekers have a legitimate concern that such pricing structures (which load common costs onto uncompetitive routes), create a large differential between incremental cost and access charges, giving Telstra a competitive advantage in downstream markets in which it competes with access seekers.

In our view, where possible potential downstream advantages would best be solved by more efficient price structures for transmission, if possible based on fixed charges which are either upfront or do not vary with bandwidth. The basic principle is that, where possible, access seekers should be given the same cost structure as Telstra. We believe this should be a guiding principle for the ACCC in determining DTCS pricing.

6. PRICE LEVELS

We have significant concerns with Frontier Economic's arguments regarding build/versus buy and the rationale that TSLRIC is still appropriate when the routes are 'potentially competitive'. In our view, sending efficient build versus buy incentives does not require that prices be based on replacement costs. Such prices may indeed cause inefficient bypass and they will definitely cause prices to fluctuate depending on forecast/actual future prices.

As a matter of economics, it is only efficient for an access seeker to bypass the access provider's network when the cost of the services provided by the new network is less than the cost that would have been incurred in providing those services over the existing network (ignoring any additional benefits from providing services on the new network). Critically, the access price which encourages efficient bypass is one that is therefore no greater than the costs avoided as a result of not providing those services on the existing network – a cost which is likely to be far less than the 'forward looking efficient cost' of building an optimised replacement network.

Therefore, in our view there is simply no reason for Frontier Economics and the ACCC to persist in arguing that TSLRIC, based on periodic asset revaluation, is at all relevant to build/buy incentives.

Moreover, as has been extensively written about elsewhere⁴, periodic asset revaluation creates significant uncertainty for access seekers and access providers as prices are based on forecast price trends for labour and equipment, which are inevitably wrong and when updated mean prices fluctuate wildly (and for no economic purpose).

In our view, the key issue for the regulated transmission services is that price levels have historically not been set by the regulator and therefore there is no existing asset value. Therefore, a key issue for the ACCC to consider is: how should transmission assets be valued for the first time? As there is no history of prices, there appears to be wide discretion as to determining what asset value is 'reasonable'. As much of the assets have been incurred historically and are sunk, efficiency suggests a very low asset value and the primary factor driving a non-zero asset value is what is a 'fair' value for those assets which satisfies Telstra's legitimate business expectations. In our view, such an asset value would necessarily take into account past cost recovery.

We also consider that asset valuation should take into account the effect competition has had on Telstra's asset value. That is, that Telstra's assets in competitive areas should not be valued at any more than the revenue it expects to receive in those areas. This would ensure that costs associated with competitive areas are not recovered from ('subsidised by') uncompetitive areas.

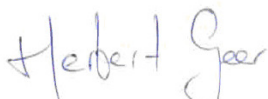
7. CONCLUSION

We appreciate the opportunity to respond to the ACCC's DTCS pricing inquiry on iiNet's behalf. For the reasons set out above, we request that the ACCC have regard to the following approach when determining DTCS access prices:

- less aggregation and less cost averaging across different transmission services and routes;
- price structures which focus on fixed costs and on-going charges which maximise incentives to use the service; and
- prices set at a level to achieve past cost recovery rather than continually revaluing assets.

We would welcome an opportunity to discuss the matters raised in this submission with you.

Yours faithfully



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cc (by email) Joshua Davies, Assistant Director, Communications Group, ACCC
Steve Dalby, Chief Regulatory Officer, iiNet

⁴ See for example: Competition Economists Group, *Reform of Part XIC: Regulatory Certainty - Increasing regulatory certainty for telecommunications assets in Australia - A report for Optus*, pp21 - 30; available at <http://www.accc.gov.au/content/index.phtml/itemId/916378>.