Draft Determination for model price terms and conditions of the PSTN, ULLS and LCS services

Submission to the ACCC by AAPT Limited

23 July 2003

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1 Introduction

1 This submission primarily responds to the Commission's June 2003 *Draft Determination for model price terms and conditions of the PSTN, ULLS and LCS services*.

2 While the Commission's model terms and conditions are non-binding, they are nevertheless likely to form the basis for negotiated prices. Further, any arbitration determination is expected to reflect the model terms and conditions. The model terms and conditions, therefore, are likely to have a substantial effect on the market for the period of the determination and beyond.

3 Given this, AAPT has two broad concerns. First, the Commission's model price terms and conditions should be determined on the basis of pricing principles and a pricing methodology that has been thoroughly analysed and investigated by the Commission and interested parties, and which has been found to promote the legislative criteria. AAPT is particularly concerned that the PIE II model has not been appropriately analysed and that, in its current state, the model will suggest access prices that are inappropriately high. AAPT suggests that the benchmarks should be redetermined following a fuller assessment of the model. AAPT also notes that the Commission is yet to rigorously estimate the efficient costs of LCS.

4 Second, the Commission's model price terms and conditions should be sufficiently flexible to allow commercial negotiations to take place. AAPT is concerned that overly prescriptive model price terms and conditions will impede commercial arrangements, thereby undermining the very purpose of the model terms and conditions.

5 The remainder of this submission will comment on particular aspects of the Commission's Draft Determination. Where relevant, AAPT refers the Commission to its previous submission on access deficit contribution (**ADC**) issues, and its forthcoming submission on Telstra's undertakings, for more detailed comments.

2 PSTN O/T services and the ULLS

2.1 Appropriate pricing principles

6 AAPT supports the use of TSLRIC to model efficient forward-looking costs. AAPT agrees with the Commission's conclusion that, in general, access prices based on a

forward-looking TSLRIC are consistent with prices that would prevail in the presence of effective competition and best promote the long-term interests of end-users, including by encouraging economically efficient investment in infrastructure.[1]

7 AAPT also supports the Commission's determination that both the PSTN O/T services and the ULLS meet the criteria, outlined by the Commission in their *Access Pricing Principles – Telecommunications*, under which TSLRIC pricing is appropriate.

8 However, as a result of AAPT's strong support of a TSLRIC approach to the assessment of efficient costs, AAPT is concerned that the model used to assess the efficient costs of the PSTN and ULLS should actually adopt a TSLRIC approach. In particular, and as discussed further below, AAPT has concerns about the use of Telstra's PIE II model on the basis that the model is in fact a TELRIC model rather than a TSLRIC model. A TELRIC model will almost always fail to include the full range of services necessary for a true TSLRIC model, and will effectively create a stand-alone cost model.

2.2 Modelling framework

(a) The appropriate model

9 AAPT is concerned that the Commission intends to use Telstra's PIE II model "to inform itself in relation to determining model price terms and conditions."[2] In AAPT's submission, Telstra's PIE II will systematically overstate the efficient costs of the network. The flaws in the PIE II model are such that, at present, the model's value even as an indication of the ceiling of efficient costs is limited.

10 In the interests of forming an adequate view of the appropriateness of the PIE II model, AAPT has made several requests to Telstra for relevant information. AAPT is still waiting for Telstra to provide a response to some of these requests. Consequently, AAPT has not yet been able to analyse the PIE II model to its satisfaction. AAPT intends to provide more detailed comments in its submission on Telstra's Undertakings, which will be submitted by 1 August 2003. However, even at this stage, with the information AAPT has been provided with, it is clear that the PIE II model suffers from flaws. These include, but are not limited to, the following:

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1 ACCC, *Access Pricing Principles – Telecommunications*, 1997 (*ACCC Pricing Principles*), page 29.

2 ACCC, *Draft Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, June 2003 (*ACCC Draft Determination*), page 26.

(a) PIE II is a TELRIC model not a TSLRIC model. As will be discussed more fully in AAPT's submission on Telstra's undertakings, and supported by an expert economic statement, TELRIC models in general, and PIE II in particular, systematically overstate the efficient costs of providing a service because they almost always fail to include the full range of services and effectively create a stand-alone model. The economically efficient approach is to start with the identification of a truly incremental cost, rather than an average or stand-alone cost. To the extent that common costs are added, that should be done having regard to demand sensitivities and the implications for allocative efficiency. Telstra's PIE II departs from this standard and, as a consequence, overstates the efficient cost. That is a matter the Commission needs to take into account in any use it might make of PIE II in determining appropriate indicative price terms; and

(b) as discussed in section 2.3 below, many of the inputs adopted by Telstra in their PIE II model are inappropriate and are likely to lead to an overstatement of efficient network costs.

11 Due to these difficulties with the PIE II model, AAPT submits that the Commission should not use the model in its current form to inform its pricing decision, and certainly should not use the PIE II model as the basis for setting binding prices. AAPT's concerns regarding the PIE II model would remain even if the Commission were to adjust some of the input assumptions that Telstra proposes. In other words, it is the configuration of the model itself, as well as the inputs into the model, that lead AAPT to suggest that the model is inappropriate in its current form.

(b) Applying an adjustment factor

12 In relation to the use of adjustment factors, AAPT refers the Commission to its comments in its April submission on model price terms and conditions.[3] In that submission AAPT noted its concern that any point estimates of adjustment factors would be "unnecessarily prescriptive" and would "interfere with the promotion of commercial agreements".[4]

13 This continues to be AAPT's position on the application of an adjustment factor. However, it is difficult to comment conclusively on the Commission's view that an adjustment factor is unwarranted until the PIE II model is appropriately specified.

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[3] AAPT, *Model Price Terms and Conditions for PSTN, ULLS and LCS, Submission to the ACCC*, April 2003 (*AAPT Model Price Submission*).

(c) Price ranges or points

14 In relation to whether the Commission should issue a model price point or model price ranges, AAPT restates its preference for price ranges.[5]

15 As the Commission recognises in its *Access Pricing Principles – Telecommunications*, "[i]n many cases estimates of TSLRIC may provide a range of prices."[6] Where this is the case it may be inappropriate to attempt to specify benchmark prices to a greater degree of accuracy than the model provides. The issue of the degree of accuracy of the model may be particularly pertinent if the Commission decides to model efficient costs on the basis of Telstra's PIE II model. One reason for this is that the results of the PIE II model will need to be adjusted in light of the fact that the model is a TELRIC model rather than a TSLRIC model.

16 AAPT further submits that, where a range of prices is published, it would also be appropriate to publish guidelines as to the factors that would influence the price within the range that a particular access seeker could expect to pay. AAPT considers that one of the bases for determining the particular price should be the volume of the service required by an access seeker.

2.3 Appropriate inputs

17 In its Draft Determination, the Commission stated a preliminary acceptance of the following input factors as specified in Telstra's PIE II model:

(a) routing factors;

(b) traffic and service volume estimates;

(c) network provisioning;

(d) asset prices and lives;

(e) operation and maintenance costs; and

(f) indirect (organisational level) costs.

18 AAPT is concerned by the Commission's preliminary acceptance of these inputs as specified by Telstra. AAPT submits that many of these input factors are inappropriately

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[4] *AAPT Model Price Submission*, page 4.

[5] *AAPT Model Price Submission*, pages 3-4.

[6] *ACCC Pricing Principles*, page 35.

specified by Telstra. At this stage, AAPT has not had adequate opportunity to investigate Telstra's assumptions and, in some cases, has not been provided by Telstra with information necessary for a complete investigation of these assumptions. For these reasons, AAPT intends to comment more fully on the appropriateness of Telstra's inputs in its submission on Telstra's undertakings.

19 AAPT will also provide more complete comments on Telstra's assumptions regarding trench sharing, WACC and network planning costs in its submission on Telstra's undertakings, but is now in a position to make the following preliminary comments.

(a) Trench sharing

20 In its undertakings, Telstra proposes to treat 1 per cent of services as connected in new estates:

> *"Telstra estimates that during any particular year there are at most 1% of services connected in new estates, where Telstra can share trenches with others. As the cost of trenches in new estates are usually borne by estate developers, the PIE II model excludes 1% of trench costs from the PSTN cost pool."*[7]

21 AAPT supports the Commission's current view that Telstra's treatment of trench sharing in new estates is mistaken. AAPT agrees that the PIE II model should reflect both Telstra's ability to share trenches over the regulatory period and its past ability to share trenches.

22 However, AAPT is concerned that the Commission's current view as to the percentage of new estates is conservative. The Commission itself recognises that its assumption is conservative in stating that its assumption that new estates make up 13 per cent of Telstra's networks is "[b]ased on conservative estimates of the accumulative stock of new estates over the last 10 years."[8] AAPT understands that assumptions made in the n/e/r/a model indicate that the proportion of new estates in Telstra's networks may in fact be greater than 13 per cent. AAPT submits that a careful analysis of Telstra's network is necessary before an appropriate assumption regarding the proportion of new estates in Telstra's networks can be made.

23 AAPT also notes that, excluding Telstra's assumptions regarding new estates, the Commission's preliminary view is that it will adopt the trench sharing assumptions made

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[7] *Telstra's Submission in Relation to the Methodology used for Deriving Prices Proposed in its Undertakings*, 9 January 2003 (*Telstra's Submission on Methodology*), page 9.

[8] *ACCC Draft Determination*, page 30.

by Telstra in its PIE II model. Clearly, in a forward-looking TSLRIC model, it is necessary that trench sharing assumptions reflect the extent to which an efficient operator would engage in trench sharing if it were currently rolling out a network. AAPT is concerned that Telstra's trench sharing assumptions may not be appropriately forward-looking, but may reflect Telstra's actual historic trench sharing, which is likely to have been less than would be efficiently engaged in today. For this reason, AAPT submits that Telstra's trench sharing assumptions should be verified by a careful analysis of the extent to which an efficient network operator would trench share.

(b) WACC

24 The Commission has stated that its preliminary view is to adopt WACC parameters similar to those set out in its second PSTN undertaking,[9] with the exception of the risk-free rate and the debt-issuance costs.

25 On the basis of its initial investigations, AAPT supports the Commission's scepticism regarding the WACC input assumptions used by Telstra in its undertakings. AAPT will comment further on Telstra's assumptions in its submission on Telstra's undertakings.

(c) Network planning costs

26 AAPT supports the Commission's current view that Telstra's proposal to include network planning costs in its PIE II model is inappropriate. AAPT cannot see any relevant justification for the inclusion of such costs.

2.4 PSTN – the access deficit contribution

27 AAPT has provided extensive comments on the ADC in two previous submissions to the Commission.[10] Annexed to the second of these – submitted to the Commission in July 2003 – are three expert economic reports that support AAPT's contention that the inclusion of an ADC in access prices is inappropriate.

28 For a full understanding of AAPT's position on the ADC the Commission should refer to these earlier submission. However, AAPT's opposition to the ADC can be briefly summarised as follows:

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[9] ACCC, *A Report on the Assessment of Telstra's Undertakings for the Domestic PSTN Originating and Terminating Access Services*, July 2000.

[10] AAPT, *The Need for an ADC for PSTN Access Service Pricing, Submission to the ACCC*, February 2003; AAPT, *ACCC Draft Determination for Model Price Terms and Conditions of the PSTN, ULLS and LCS Services and*

(a) it is not clear that the retail price caps imposed on Telstra in respect of line rental and connection fees do in fact constrain Telstra. Both Telstra and the Commission propose that an ADC is to account for the gap between line costs and line revenues which Telstra is unable to close owing to the existence of the retail price caps. However, if these price caps are not a constraint, then the access deficit is willingly incurred by Telstra for commercially legitimate reasons and should not be funded by access seekers;

(b) to consider that there exists an access deficit that requires funding from access seekers is to inappropriately treat basic access – which is part of a joint product – as a stand-alone product. Considered as a joint product, it is clear that Telstra earns adequate returns on, and invests appropriately in, the provision of basic access even without an ADC;

(c) if Telstra were not to earn adequate returns on the provision of basic access, the universal service obligation (**USO**) scheme guarantees that Telstra will be subsidised for its losses even in the absence of an ADC; and

(d) even if it were held that, despite (a), (b) and (c) above, access seekers should contribute to the costs of providing basic access through some mechanism in addition to the USO scheme, the current ADC does not meet the criteria for efficient recovery of CAN costs.

29 Furthermore, AAPT submits that the inclusion of an ADC in access prices does not contribute to the legislative criteria to which the Commission must have regard when determining model prices and considering Telstra's undertakings. In fact, the legislative criteria are best promoted by a rapid removal of the ADC from access prices.

30 It is clear that there is significant agreement between AAPT's position on the ADC and the Commission's current views on the ADC, as expressed in the Draft Determination. However, for reasons outlined in its July 2003 submission on the ADC, AAPT submits that the most appropriate policy is to completely remove the ADC from access prices 12 months from the date of issue of the Commission's Draft Determination, rather than gradually phase out the ADC as proposed by the Commission.

ACCC Discussion Paper on Telstra's Undertakings for Domestic PSTN Originating and Terminating Access, ULLS and LCS: Access Deficit Contribution Aspects, July 2003.

2.5 Draft model access prices for the PSTN O/T services

31 While AAPT welcomes the Commission's view that the ADC should ultimately be removed from access prices, AAPT nevertheless has several concerns with the Commission's model access prices for the PSTN O/T services.

32 First, AAPT notes that the model access prices are specified for the 3 years up until 2005-06, but that the Determination will remain in place for 5 years. It is difficult to conclusively comment on the Commission's model access prices without clarification as to how access prices beyond 2005-06 are to be determined. AAPT suggests that an appropriate approach may be to redetermine model prices next year following a fuller assessment of Telstra's PIE II model. Once the model has been adequately assessed, AAPT suggests that it is appropriate for the Commission to provide prospective prices going forward for either of 3 years or 5 years, but that these prices should be re-set each year.

33 Second, AAPT is concerned that the Commission's estimates of conveyance costs, ADC costs and wholesale costs, as they appear in the Draft Determination,[11] are based on Telstra's PIE II model, with some inputs adjusted. As stated above, and as will be discussed more fully in AAPT's submission on Telstra's undertakings, AAPT has three broad concerns:

(a) AAPT disputes the accuracy of some of the input assumptions used by Telstra that have been accepted by the Commission;

(b) AAPT considers that, even with correct inputs, the PIE II model is still flawed in such a way as to overstate efficient costs; and

(c) AAPT is concerned that, as a TELRIC model, PIE II, even appropriately adjusted and with reasonable inputs, will systematically overstate efficient costs such that the results of PIE II can only be treated as a price ceiling.

34 Third, AAPT is concerned with the Commission's approach to phasing out the ADC. Based on a comparison of the headline PSTN costs estimated by the Commission[12] with the Commission's draft model access prices,[13] it would appear that, in the initial years of the determination, the Commission's model price exceeds the Commission's own

[11] *ACCC Draft Determination*, pages 52-53.

[12] *ACCC Draft Determination*, page 53.

[13] *ACCC Draft Determination*, page 54.

estimation of PSTN costs (including ADC). This view of the Commission's approach is supported by the Commission's discussion in its Draft Determination:

> *"The approach proposed by the Commission, as noted in section 8.8 above, which follows discussions with Telstra, results in access prices that are initially higher than what would exist under the current ADC approach, noted in the PSTN O/T costs above."*[14]

It would seem that the Commission's justification for the fact that the model prices exceed its own estimation of PSTN costs (including ADC) is that Telstra needs to be compensated for the loss of the ADC:

> *"This is because some allowance needs to be made for the fact that in later periods access prices will be lower that what would occur under the current ADC approach and that the ADC will be removed earlier than otherwise (by the beginning of 2006-07)."*

35 If it is indeed the Commission's determination that, having found that the ADC is "a significant distortion to competitive and efficient outcomes",[15] and that the ADC should be "removed from access prices as soon as practicable",[16] access prices should nevertheless exceed the level they would be at even with the addition of an ADC to the efficient costs of providing access, then AAPT submits that this is inappropriate. AAPT's concerns include the following:

(a) to increase access prices above the level that they would be at with an ADC will only create a more significant distortion to competitive and efficient outcomes as prices become further divorced from cost;

(b) AAPT notes that the Commission considers that high initial access prices should be offset by lower access prices in later years:

> *"In addition, such an approach does not countenance access charges being higher than relevant costs (including as ADC) overall, but notes that in the early period this is the case which is then offset by lower charges in later periods."*[17]

AAPT has several concerns with this offsetting, including the following:

(1) the methodology by which the Commission has determined that the high access charges are offset by the low access charges is unclear.

[14] *ACCC Draft Determination*, page 53.

[15] *ACCC Draft Determination*, page 2.

[16] *ACCC Draft Determination*, page 2.

[17] *ACCC Draft Determination*, page 53.

This makes it difficult for the interested parties to comment on this offsetting;

(2) it is unclear why the Commission chooses the relevant costs *including ADC* as the point of comparison, given that the Commission also holds the view that the inclusion of an ADC deters competition and distorts efficiency. It would seem to AAPT that relevant costs excluding the ADC would be a more logical point of comparison for the intertemporally averaged access charges; and

(3) the justification for such offsetting is unclear. If the ADC distorts competition and efficiency, it should be removed. To rebalance access prices around the level that they would be at with an ADC is simply to increase the distortions already inherent in the inclusion of an ADC in access prices;

(c) AAPT fails to understand the benefit that would balance the detriment of these access prices in excess of those that would occur with an ADC. It may be the case that the Commission is concerned about Telstra's investment incentives. However, elsewhere the Commission does not seem to think that Telstra's investment incentives are materially affected by the removal of an ADC.[18] It may also be the case that the Commission is concerned not to disadvantage access seekers engaged in commercial access agreements with Telstra:

> *"The Commission's proposed approach also recognises the reality of existing levels of commercially agreed access prices . . ."*[19]

However, AAPT is concerned that the Commission has not investigated the nature of existing access arrangements: in particular, AAPT questions whether it is indeed the case that a significant number of access seekers are engaged in arrangements that include access prices set on the basis of the ADC as previously calculated, and whether it is the case that such access seekers are bound to these arrangements for a significant period of time.

[18] *ACCC Draft Determination*, page 2.

[19] *ACCC Draft Determination*, page 53.

In short, if it is indeed the Commission's contention that access prices should initially exceed the PSTN costs including the ADC, before later falling below this level, then AAPT does not consider that this is consistent with the legislative criteria.

36 In conclusion, AAPT notes that the Commission's preliminary assessment of the PIE II model "may be subject to change once a thorough and comprehensive audit of the model has been undertaken",[20] suggests that such an audit should be undertaken, taking into account submissions in response to Telstra's undertakings, and submits that the Commission should revisit its draft model prices for PSTN O/T services once this audit has been completed.

2.6 ULLS – network and non-network costs

(a) Network costs for the ULLS

37 In relation to the Commission's proposal to use the PIE II model to estimate the efficient network costs for the ULLS, and in relation to the Commission's views on the appropriate inputs into the model, AAPT refers the Commission to its statements on PIE II made above and to the more detailed analysis of the PIE II model that will be provided in AAPT's submission on Telstra's undertakings.

38 In relation to the use of de-averaged prices for the ULLS, AAPT supports the Commission's view that de-averaged prices are appropriate. AAPT will provide detailed comments on Telstra's proposal to average ULLS prices across what had previously been defined as Bands 2, 3, and 4 in its submission on Telstra's undertakings. In brief, AAPT's position is that, as a general principle, access prices for a service should reflect the costs of providing that service. Band averaging, however, will create a disjuncture between prices and costs, with detrimental effects on competition and investment incentives and, ultimately, the LTIE.

39 AAPT also supports the Commission's view that an ADC is not necessary for the ULLS.

40 In relation to the Commission's proposed ULLS network costs, AAPT submits that these costs are likely to be overstated due to flaws in the PIE II model, and inappropriate inputs into the PIE II model that are used by Telstra and have been adopted by the Commission. AAPT suggests that a "thorough and comprehensive" audit of the PIE II model will likely

[20] *ACCC Draft Determination*, page 55.

reveal these problems and that the Commission should then re-assess these proposed ULLS network costs.

(b) ULLS-specific costs

41 In regard to ULLS-specific costs, AAPT welcomes the Commission's current view that it is appropriate to largely adopt the underlying ULLS-specific costs estimated by CMPI/AAS, rather than those estimated by Telstra. AAPT is generally concerned that Telstra has an incentive to overstate costs and supports the Commission's use of independent consultants to test the appropriateness of Telstra's assumptions. The need to be cautious of Telstra's assumptions is highlighted by the previous conclusion by CMPI/AAS that the costs associated with ULLS-specific activities were only about 22 per cent of those then proposed by Telstra. Further, as Telstra has not made available for industry scrutiny the inputs to its ULLS specific costs, the Commission should give little weight to Telstra's estimates.

42 AAPT is concerned, however, that the Commission may have underestimated the take up of ULLS in the future. AAPT notes that the Commission's demand estimates are significantly below those estimated by CMPI/AAS, and considers that the Commission may be overly cautious given recent demand figures. The Commission has assumed a demand of approximately 1.5 million broadband lines over the next three years. AAPT considers this figure is conservative, particularly in light of Telstra's prediction as recently as 18 May 2003 that it alone will have 1 million broadband customers within two years, from a current base of 360,000. AAPT is particularly concerned that the Commission's lower demand estimates may become self-fulfilling as the associated higher price of access, and higher retail prices, decrease the take-up of ULLS. The objectives of the Part XIC access regime include the promotion of competition, which is to be assessed with regard to the extent to which obstacles are removed to end users gaining access to services. It would be counter to this objective if an inappropriately low demand estimate had the result of setting model prices at a level that would reduce the demand for a declared service. In light of the detrimental effect on ULLS costs of underestimating ULLS demand, AAPT considers the Commission should adopt a demand estimate within the range of the CMPI/AAS previous demand estimate of 400,000 to 500,000 unless there is a strong justification for applying an alternative estimate.

3 Local carriage service

3.1 Appropriate pricing principles

43 In relation to the appropriate pricing principle for LCS, AAPT notes that the Commission's current approach is to favour a retail-minus methodology on the expectation that:

> *"the TSLRIC++ along with retail costs of a local call exceed the maximum price of 20 cents (GST inclusive) that Telstra is able to charge under the price control arrangements."*[21]

44 AAPT also notes that the Commission considers that this situation may be subject to change:

> *"On this basis the Commission's view is that the retail minus approach be used to estimate the LCS price for 2002-03 and 2003-04. In subsequent years it is likely the TSLRIC++ (plus retail costs) of a local call will be below 20 cents and as such there is no apparent reason why the TSLRIC++ approach should not be considered."*[22]

45 AAPT considers that, given the Commission's apparent uncertainty as to whether the TSLRIC of LCS is above or below the retail price cap, and given the Commission has not undertaken a cost study for LCS, it is appropriate for the Commission to undertake to estimate the costs of providing LCS access services. In this way the Commission and interested parties will have greater certainty as to the appropriate pricing methodology and the Commission will be better placed to ensure that the model access prices are those that best promote the legislative criteria.

46 In undertaking this cost modelling exercise, AAPT suggests that the Commission should model the TSLRIC+ of LCS rather than the TSLRIC++. The Commission's Draft Determination makes it clear that the ADC is distortionary and inefficient and that it should be removed from the access prices for PSTN and ULLS. AAPT sees no reason why the ADC should remain a component of the access price for LCS.

[21] *ACCC Draft Determination*, page 69.

[22] *ACCC Draft Determination*, page 69.

3.2 Draft model access prices for the LCS

47 In relation to the Commission’s draft access prices for LCS, AAPT reiterates several points made in respect of the draft access prices for PSTN and ULLS:

(a) Given that the Commission’s determination will remain in force for 5 years, AAPT suggests that the Commission should be clear as to the access prices in later years of the determination period. It is difficult to conclusively comment on the Commission’s Draft Determination without such clarification; and

(b) AAPT supports the Commission’s current view that model access prices should be specified in a range, rather than as a point estimate, as best promoting commercial agreements.