



**ACCC DRAFT DETERMINATION FOR MODEL PRICE TERMS
AND CONDITIONS OF THE PSTN, ULLS AND LCS SERVICES**

AND

**ACCC DISCUSSION PAPER ON
TELSTRA'S UNDERTAKINGS FOR DOMESTIC PSTN
ORIGINATING AND TERMINATING ACCESS,
UNCONDITIONED LOCAL LOOP SERVICE AND LOCAL
CARRIAGE SERVICE**

ACCESS DEFICIT CONTRIBUTION ASPECTS

**Submission to the ACCC by AAPT Limited
9 July 2003**

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Executive summary

- 1 AAPT supports the Commission's finding in its Draft Determination of 18 June 2003 that the inclusion of an access deficit contribution (**ADC**) in access prices creates a significant distortion to competitive and efficient outcomes.
- 2 AAPT submits that the ADC is inappropriate for the following reasons:
 - (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 customer access network (**CAN**) costs.
- 3 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. For the reasons outlined in this submission, 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.

Introduction

- 4 This submission comments on the ADC related aspects of the Commission's Draft Determination released on 18 June 2003. A further submission addressing other issues raised in the Draft Determination will be lodged by the due date for responsive submissions, 18 July 2003. The Commission is also asked to have regard to this submission in its assessment of Telstra's undertakings lodged on 9 January 2003.
- 5 In its February submission¹ on the need for an ADC, AAPT commented upon the questions raised by the Commission in its discussion paper on the ADC, as well as on certain other issues. AAPT refers to and adopts that submission for the purpose of this response.
- 6 In this submission, AAPT further develops aspects of its February submission and applies the arguments in that submission to the legislative criteria applicable to the assessment of undertakings by the Commission and the arbitration of disputes. Of particular importance in this context are the criteria relating to the promotion of competition² and the economically efficient use of, and investment in, the underlying telecommunications infrastructure.³ Consideration of these criteria necessarily incorporates considerations of allocative efficiency that are raised by both the reference to efficient use of infrastructure and efficient investment in infrastructure. The importance of the goal of allocative efficiency, and curbing the distortions which flow from market power and "monopoly" pricing, is recognised in competition policy generally and in respect of telecommunications regulation in particular.⁴
- 7 This submission also comments on Telstra's February submission on the ADC and encloses three economic reports on ADC and related issues.

¹ AAPT, *The Need for an ADC for PSTN Access Service Pricing, Submission to the ACCC by AAPT Limited*, February 2003 ("AAPT ADC Submission").

² See paragraph 152AB(2)(c) of the Trade Practices Act 1974 (Act).

³ See paragraph 152AB(2)(e) of the Act.

⁴ See, for example, the discussion of the inter-dependency between the elements of the economic efficiency with which the Commission is concerned in ACCC, *Access Pricing Principles - Telecommunications: A Guide*, July 1997 ("ACCC Access Pricing Principles"), page 7. The Productivity Commission has accredited allocative efficiency a primary role in the context of telecommunications: Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report, 2001* ("PC Telecommunications Report"), pages 374-5. As the Full Court of the Supreme Court of Western Australia recently noted in *Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Limited*, [2002] WASCA 213, this factor is to be viewed "...from the perspective of society

Analytical approach

8 The Commission's approach prior to the Draft Determination has been to accept the appropriateness of imposing an ADC, despite its associated distortions, because an ADC was assumed to be necessary in order for Telstra to recover its line-related costs.⁵ The recovery of line-related costs was thought to give rise to an issue because of the operation of retail price regulations affecting line rentals and connection revenue. The need to recover economically efficient costs is related to investment incentives and the legislative objective of encouraging efficient investment in infrastructure. It is also considered relevant to an assessment of the legitimate business interests of the owner of the infrastructure.⁶

9 In its Draft Determination, the Commission adopts a different stance on the ADC in its finding that the legislative criteria are best met by phasing out the ADC over three years.⁷

10 AAPT supports the Commission's recognition that the ADC is a significant distortion to efficiency and competition,⁸ and that the ADC should be excluded from access charges. AAPT further suggests that, having regard to the criteria relevant to undertaking assessments, the Commission should proceed as follows in determining the appropriate treatment of the ADC:

- (a) it must assess whether the retail price regulations in fact constrain Telstra;
- (b) it must assess whether Telstra is able to recover its line-related costs from retail telephony and other services which use basic access, such as local, long-distance and international telephony services;
- (c) it must consider the fact that the USO guarantees the recovery of line-related costs in all exchange service areas (**ESAs**) where these costs are not recovered from telephony services;

[and] ... most naturally relates to the objective ... of the promotion of a competitive market and, perhaps, also to the prevention of the abuse of monopoly power" (at paragraph 61).

⁵ ACCC, *The Need for an ADC for PSTN Access Service Pricing*, February 2003 ("ACCC ADC Discussion Paper"), page 2.

⁶ Paragraph 152AH(1)(b) of the Act.

⁷ ACCC, *Draft Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, June 2003 ("ACCC Draft Determination"), pages 49-50.

⁸ ACCC *Draft Determination*, page 2.

- (d) it must test the extent to which Telstra imposes an ADC on its own retail division; and
- (e) it must assess, from the perspective of allocative efficiency, the appropriate way in which to recover CAN costs and test that against what Telstra proposes and what Telstra in fact does.

11 This analysis will inform the Commission of the extent to which the assumed need for an ADC in fact exists and of the consequences, in terms of the relevant legislative criteria, of imposing it. AAPT addresses each of these issues below.

Whether the price controls in fact constrain Telstra

12 In its February submission, AAPT directed the Commission to the question of the extent to which Telstra is constrained by the retail price controls.⁹

13 The extent of the constraint imposed by these price controls is fundamental in several respects. If Telstra is not constrained by the price controls, it can only be that Telstra has exercised its pricing discretion in respect of line rentals and connection revenue to achieve the most profitable pricing structure, and has found that the most profitable pricing strategy involves charging a price for basic access below that which is required by regulation. If Telstra finds it most profitable to earn revenues directly attributable to basic access that are lower than the costs of basic access, then this justifies questioning whether there is now, or ever was, any genuine need to impose an ADC on access seekers in order to encourage efficient investment in infrastructure and to have regard to Telstra's legitimate business interests. The constraint imposed by price controls is therefore a matter of direct relevance to the Commission's assumed justification for the contribution.¹⁰ It is also relevant to Telstra's justification for the contribution because Telstra claims that the access deficit is "due to" the retail price controls.¹¹

14 Additionally, if it is the case that Telstra is not constrained by the price controls, the arbitrariness of the access deficit becomes apparent. If Telstra prices below the price controls, the size of the access deficit is determined by the level of the retail price control

⁹ *AAPT ADC Submission*, page 7.

¹⁰ Describing its present practice, the Commission notes that access seekers are required to contribute to the deficit "resulting from the operation of retail price controls that limit Telstra's ability to retrieve its line costs directly from line rentals on its own retail customers." See *ACCC Draft Determination*, page 34.

¹¹ *Telstra ADC Submission*, paragraphs 1 and 29.

rather than by the deficit Telstra chooses to incur in setting its price. In this case, the size of the access deficit can be arbitrarily changed – even eliminated – simply by altering the non-binding price control, without affecting any actual behaviour. Gans and King discuss this point in their submission to the Commission in February 2003:

“In this situation, to define an ‘access deficit’ on the basis of a non-binding price cap has no economic meaning. The deficit could be eliminated by simply raising the (non-binding) price cap. As the cap is not binding, increasing the cap has no effect on any actual market behaviour.”¹²

- 15 Whether the price controls constrain Telstra is essentially a factual issue. A summary of the price control arrangements that have applied to Telstra from time to time since 1989 has been prepared by the Commission.¹³ A principal objective of those controls, as recorded in the Commission’s summary, was to provide Telstra the opportunity to efficiently restructure prices in order to recover the common costs of service provision in the most efficient fashion. Each set of price control arrangements has allowed Telstra the opportunity to increase line rentals and give it some flexibility to determine the magnitude and timing (including carry-over provisions) of any increases.
- 16 The main control that has existed since July 1999 is a sub-cap of CPI - 0 on a basket of local calls and line rentals. This has given Telstra flexibility in how it has priced various products to end-users. This means that any number of prices or combination of prices may result in compliance with this price control arrangement.
- 17 Because Telstra has flexibility in setting the price of basic access, the actual price of basic access need not be the maximum allowable under the price control.
- 18 The Commission has acknowledged this degree of discretion in its assessment of Telstra’s undertaking in 2000.¹⁴ For this reason, the Commission concluded that Telstra’s chosen level of basic access charges should not determine the access deficit; to do so would provide Telstra with an incentive to minimise increases in basic access prices in order to maintain the access deficit at a high level (and thereby impose costs on its downstream competitors). Accordingly, the Commission concluded that the access deficit

¹² J Gans and S King, *The Access Deficit Contribution for PSTN Interconnection Pricing, a Submission to the Australian Competition and Consumer Commission*, 26 February 2003 (“Gans and King ADC Submission”), page 8.

¹³ ACCC, *Review of price control arrangements*, February 2001.

¹⁴ ACCC, *A Report on the Assessment of Telstra’s Undertaking for the Domestic PSTN Originating and Terminating Access Services*, July 2000, section 7.3.3.

should be calculated on the basis of the extent to which the price controls prevent Telstra from recovering costs from basic access charges – that is, by looking to the maximum possible price for basic access under the price control.¹⁵

19 The following observations may be made about Telstra's actual pricing of basic access:

- (a) prior to 1999/2000, there appear to have been instances where Telstra's actual prices for basic access were below the maximum price permitted under the price controls. In December 1998, the Commission reported that, during the period 1992 to 1998, business line rentals increased twice and fell once by an amount which exceeded the two increases, while non-business rentals only increased twice;¹⁶
- (b) in the Commission's summary of Telstra's compliance with the price control arrangements in the 1999/2000 financial year, it concluded it was satisfied Telstra had complied with the price control arrangements. The report also noted several instances where Telstra had exceeded the requirements – that is, the overall reduction in the revenue weighted prices for the particular basket exceeded that Telstra was required to achieve in order to comply;¹⁷ and
- (c) as noted above, the main price control on basic access since July 1999 has been on a basket of local calls and line rentals which has afforded Telstra some flexibility in how it has priced these products to end users. Telstra has since offered pricing alternatives to the standard prices for basic access and local calls. Initially, these options were identified as EasySaver packages, which charge higher line rental in return for lower local call charges and a requirement to pre-select Telstra for long distance. These packages have increased in number and evolved with the additional products being added to the basic access/local call bundle.

20 Telstra's pricing behaviour in respect of basic access illustrates the degree of flexibility it enjoys and the absence of a constraint of the type referred to in support of there being an access deficit that should be recovered from access seekers.

¹⁵ ACCC, *A Report on the Assessment of Telstra's Undertaking for the Domestic PSTN Originating and Terminating Access Services*, July 2000, page 67.

¹⁶ ACCC, *Telecommunications Charges in Australia*, 1998, table 1.2.

¹⁷ ACCC, *Telecommunications Competitive Safeguards and Telstra's Compliance with the Price Control Arrangements, 1999-2000*, 2001, section 9.

The nature of basic access – a joint product

- 21 The previous section illustrated how Telstra is not constrained by retail price controls and concluded that, since Telstra effectively chooses to charge fees for retail line rental and connection that provide revenues less than the total cost of providing basic access, there is no justification for interfering with Telstra's efficient pricing decisions by including an ADC in access prices.
- 22 However, AAPT notes that even if Telstra were constrained by retail price controls, the ADC is not justified. For the purposes of demonstrating this, it will be assumed in this section that the retail price controls do bind Telstra and can be said to cause Telstra's revenues from retail line rental and connection fees to fall below the total cost of providing basic access.
- 23 Having assumed this, it is necessary to consider the nature of the shortfall between the revenues from line rental and connection and the cost of providing basic access. In doing so it is crucial to recognise that basic access, by its nature, is part of a joint product. It has virtually no value as a product of itself, but becomes valuable (and is demanded by consumers) when it is combined with local and other call services.
- 24 With joint products, the question of whether the revenues directly attributable to an individual component cover the costs of that component has no economic or commercial relevance. To ask this question is to treat a joint product as a stand-alone product – in other words, to expect revenue directly attributable to each component of a joint product to cover the costs of that component. There is no reason that this should be the case. The relevant question is whether the total revenues from the joint product cover the total costs of the joint product.
- 25 This reality is reflected in the pricing of joint products. Suppliers of these products often do not expect to sell the individual components; nor do they expect to recover the cost of each individual component from revenues earned on that individual component. In fact, it may not be profit-maximising for the supplier to pursue such a pricing strategy.¹⁸ A failure to recover the cost of each individual component from revenues earned on that component, however, will not alter consumers' demand for the joint product, nor will it

¹⁸ Gans and King provide an example involving a razor consisting of two components, a razor-handle and a blade. See *Gans and King ADC Submission*, pages 6-7. The individual components that constitute a motor vehicle provide another example.

affect the profits earned from the joint product or the firm's incentives to invest in the joint product.

26 Returning to basic access, to question whether there is an access deficit caused by the revenues directly attributable to basic access falling below the costs of basic access is to treat basic access as a stand-alone product. It is an irrelevant question. The issue must be assessed on the basis of all the costs and revenues associated with the services into which basic access is an input.

27 Gans and King argue the point as follows:

“To evaluate any deficit created for Telstra due to price constraints on the CAN, it is necessary to consider all of Telstra's costs and revenues from providing services that involve customer access. If providing access to a customer is profitable to Telstra, when all revenues and costs associated with that customer are considered, then there is no meaningful ‘access deficit’ for that customer.”¹⁹

28 There is considerable evidence that providing basic access is extremely profitable to Telstra. It is apparent that Telstra enjoys market power in many segments of the telecommunications market – in a recent speech, the Commission's Chairman stated that “Telstra has overwhelming dominance across the telecommunications market and in almost every segment of that market.”²⁰ This lack of effective competition provides Telstra with the opportunity to earn sufficient revenues on the provision of telephony services involving basic access – such as local, long distance, international and fixed-to-mobile services – to make the provision of basic access highly profitable. That Telstra takes advantage of this opportunity is demonstrated by Telstra's substantial economic profit. Studies of the profitability of Telstra undertaken by the Commission, as well as similar appraisals by industry analysts and by Telstra itself, all suggest that the PSTN

¹⁹ *Gans and King ADC Submission*, page 8. Putting this point another way, Gans and King argue that the case for an ADC rests on the assumption of a stand alone provider of basic access:

“The economic case for the UPCC rests on a particular counterfactual exercise. That exercise is to suppose that there is a single stand alone provider of basic access who does not supply any other telecommunications or other services.”

Ultimately, Gans and King find this counterfactual unsatisfying: at the very least, it ignores the benefits to Telstra of vertical integration. See, J Gans and S King, *Evaluating Telstra's Undertaking for CAN Cost Recovery*, 25 June 2003 (“*Gans and King Evaluation*”), page 7, attached as Annexure B.

²⁰ Allan Fels, “Regulating competition in converging markets: telecommunications and broadcasting”, Speech to ABN AMRO, 30 April 2003 (“*Fels ABN Amro Speech*”). In particular, and as discussed further below, Professor Fels found that competition is ineffective in the local call services market, in the national long distance and international call markets and in the market for fixed-to-mobile services: “In the local call services market competition has had very little impact.”; “Despite the appearance of strong competition in the national long distance and international call markets, there is also evidence of ineffective competition.”; and “Unlike the market for other fixed line services – such as national and international long distance – there has been relatively little reduction in the final prices paid by consumers in recent years for fixed-to-mobile services.”

returns substantial revenues. Telstra has been described as earning “high profit margins”.²¹

- 29 Given that the services provided by Telstra using the PSTN provide Telstra with substantial economic profits, there is no meaningful or relevant deficit on the provision of basic access: the costs of basic access are more than covered through the services that Telstra provides using basic access. In these circumstances, to require access seekers to pay an ADC is to allow Telstra to recover the costs of providing basic access twice - once through the profits Telstra earns on the provision of those of its services which use basic access as an input and a second time through inflated access charges.
- 30 Recognition that basic access is a joint product is consistent with the economic principles relevant to efficient infrastructure investment and with commercial reality, including Telstra’s own conduct.
- 31 Since basic access is a joint product, incentives to invest in the supply of basic access cannot be assessed in isolation. Decisions to invest in the supply of basic access are not made on the basis of the extent to which revenues directly attributable to basic access cover the costs of basic access. Rather, decisions are made on the basis of the overall contribution of basic access to profitability.²² This is a point that the Commission recognises in its Draft Determination:

“To the extent that there are concerns with the financial position of particular services, this would appear to overlook the fact that the entire PSTN is required to produce any particular service. Thus, in the Commission’s view, it would not be prudent to abandon the entire PSTN just because one part of it was not profitable or not as profitable as some other parts. Only if the entire PSTN were in deficit would abandonment of it be a consideration.”²³

- 32 Given the significant contribution of the joint products connected with basic access to Telstra’s overall profitability, it is clear that an ADC is not required to maintain Telstra’s

²¹ In a recent speech Professor Fels stated that “Telstra has generated and continues to generate high profit margins and a high return on equity in many of its core retail services, well above its capital costs or required return to its investors.” See *Fels ABN Amro Speech*.

²² This point is made by Gans and King in these terms: “There is no reason in economics why the provider of a product that involves a number of inputs needs to receive revenues on each individual input that exactly offset that input’s cost... The sellers care about total profit, not the revenues and costs associated with each individual input”: *Gans and King ADC Submission*, page 7.

²³ *ACCC Draft Determination*, page 38.

investment incentives,²⁴ even under the assumption that retail price controls constrain Telstra's pricing of line rental and connection fees. It is profitable to provide basic access because of the profitability of services that involve basic access, and it is this profitability, not an ADC, that will drive investment. This is supported by the Commission's finding that Telstra continues to engage in significant investment in the PSTN.

33 In short, an analysis that treats basic access as a stand-alone product, and assumes that basic access must generate revenues to cover its costs, is irrelevant to a consideration of the incentives for efficient investment with which the Commission must be concerned in its assessment of the model terms and conditions and Telstra's undertakings.

34 The relevance of treating basic access as a joint product, and of calculating the access deficit in terms of the costs and revenues of all the services that involve customer access, is reinforced by Telstra's treatment of basic access in the market. Telstra does not seek to recover the entire cost of providing basic access from line rental and connection fees. As discussed in the previous section, Telstra chooses to price at a level below the price controls. Telstra seeks to recover, and does in fact recover, the costs of providing basic access from various other sources.²⁵

35 For these reasons, AAPT submits that, given the nature of basic access – the fact that it is one of many products using the relevant infrastructure and that it does not have any value as a product in itself – and the fact that Telstra earns considerable profit on providing services that involve basic access, there would be no reason that access seekers should pay an ADC to Telstra even if Telstra were in fact constrained by retail price controls.

The access deficit and the USO

36 The relevance of USO revenues to the question of whether an ADC should be charged is most clearly seen if the following is assumed:

²⁴ According to the Commission, "it is clear that what information there is available does not point to an actual or imminent crisis in PSTN investment, and that no independent assessment agrees with Telstra's pessimistic outlook." See *ACCC Draft Determination*, page 39.

²⁵ In section 4 of its Discussion Paper on the ADC, the Commission refers to evidence available in support of the proposition that Telstra more than recovers the costs of basic access from its business as a whole. The Commission also notes the comment by the Productivity Commission to the effect that there is an efficiency gain to be achieved by Telstra using its monopoly profits to reduce the contribution to fixed costs made by access charges. See *ACCC ADC Discussion Paper*, page 14.

- (a) Telstra faces strong competition in the provision of retail services which incorporate or rely upon basic access as an input and so does not earn supra-competitive returns on these retail services;
- (b) Telstra's downstream competitors do not face access charges which include an ADC; and
- (c) Telstra's line-related revenue is less than the costs of providing basic access alone.

37 This is the type of situation Telstra claims violates competitive neutrality.²⁶ Various firms all compete in the provision of services that incorporate basic access, but only Telstra contributes to the cost of basic access.

38 In these circumstances, Telstra will not recover the costs of basic access from the revenues received for the supply of its services. There will be a deficit in the sense of an under-recovery. However, that under-recovery is met by the USO revenue received by Telstra. USO revenue is designed to cover losses made by Telstra in this way. The result will be that both Telstra and its competitors will contribute to the unrecovered costs of basic access through the USO scheme.

39 In AAPT's submission, an examination of the way in which the USO payments are calculated reveals that any net losses arising from Telstra's obligation to supply basic access are funded without resort to the ADC.

40 The processes adopted by the Australian Communications Authority (ACA) examine aggregate costs at the ESA level rather than at the individual line level. A TSLRIC approach to estimating avoidable costs is used and revenues foregone relate to all revenues attributable to the ESA. Only those ESAs which are loss making are examined further. Some ESAs are split into built-up and non built-up areas to determine if the built-up area is profitable and, if so, this part of the ESA is no longer considered. The net universal service cost (NUSC), which is ultimately funded by all licensed carriers and not merely Telstra, is then the aggregate net costs of all loss making ESAs.

41 Gans and King describe the relationship between the ADC and the USO scheme in this way:

²⁶ *Telstra ADC Submission*, paragraphs 4 and 146-151.

“This simple argument [that Telstra should receive an ADC] is incomplete because Telstra receives a payment from the government for losses in providing basic access. The universal service obligation and its associated industry fund is designed to cover situations where Telstra has a customer (or an exchange area) on which it makes an overall loss – including what it earns in competition with others. Therefore, under the dire competitive scenario, where Telstra is left with no profits on services B and C [ie those services that involve basic access], Telstra’s access deficit would be precisely covered.”²⁷

42 The Commission has long recognised that USO payments and the ADC are both payments to compensate Telstra for any unrecovered costs of providing basic services and, therefore, that any USO payments Telstra receives should be deducted from the access deficit. In the past, however, the Commission has calculated the access deficit by treating basic access as a stand-alone product and, unsurprisingly, has determined that the access deficit prior to the deduction of USO funding significantly exceeds the USO funding. This is no surprise because the USO funding is calculated by including returns from all services that involve basic access on the revenue side – in other words, USO funding is calculated by treating basic access as a joint product. By also treating basic access as a joint product for the purposes of calculating the access deficit, the USO payments and the ADC will be equivalent and the USO scheme can be relied upon to compensate Telstra for any access deficit.

43 This point is made by Gans and King:

“ . . . it is the very inconsistency between the counterfactual question posed by Telstra to justify the UPCC and the application of the USO that gives rise to the potential need for a UPCC. Recall that by the way the USO is calculated recognises that a vertically integrated basic access provider, such as Telstra, has other opportunities to raise revenues (and profits) that would not be available to a stand-alone basic access provider. The USO takes into account all relevant Telstra revenues when determining a NCA. In contrast, the UPCC begins from the opposite perspective of ignoring all of Telstra’s revenues except those associated with basic customer access. At the very least, and as we noted above, this means that the approach to PSTN access adopted by Telstra in its undertaking is inconsistent with other government telecommunications policy.

. . .

If the Telstra Hypothetical were to be applied and implemented consistently then it would involve the removal . . . of the UPCC.”²⁸

44 The assumptions made in paragraph 36 are designed merely to illustrate the relationship between the ADC and the USO, and are not realistic. In particular, Telstra does not face

²⁷ Gans and King ADC Submission, page 11.

²⁸ Gans and King Evaluation, pages 14-15..

the sort of strong competition over all its retail services that is envisaged in its argument for an ADC. Rather, Telstra makes economic profits on some of these services. As a result of this, the ADC sought by Telstra in its undertakings would result in a double payment to Telstra for the CAN in those ESAs where Telstra makes an overall profit. In these ESAs, Telstra receives payment for the CAN through its profitable sale of services which require basic access as an input and would also receive compensation for the CAN through the ADC. The subtraction of USO revenue in Telstra's calculation of the ADC does not prevent this double payment.

45 As a further point, it should be pointed out that the USO payments Telstra receives whenever it fails to make an adequate return on the provision of basic access due to retail price controls will provide Telstra with more than adequate incentives to invest in the CAN. As Gans and King point out:

“The existence of the USO fund means that Telstra’s fixed costs associated with providing access will always be covered. What, however, does this mean for its incentives to invest in the CAN? Recall, that it has been argued that Telstra would have little if any incentive to invest in the CAN if it did not receive an access deficit contribution. However, Telstra’s universal service obligations require such investments and compensate Telstra for them through the USO fund. Indeed, as that fund is cost-based, if anything it may provide too much rather than too little incentive to maintain and expand the CAN. This is because Telstra is effectively reimbursed for such expenses; subject, of course, to its use of best available technologies.”²⁹

Telstra’s internal transfer price

46 An access provider’s internal transfer price for equivalent services has regulatory relevance in a cost-based access pricing regime:

- (a) it can assist in assessing whether any proposed access price is cost-based, assuming the transfer price reflects economic costs and is not purely arbitrary;³⁰ and
- (b) it can assist in the detection of discrimination between the price paid by the access provider and that paid by access seekers, which may reduce efficient competition in dependant markets.³¹

²⁹ Gans and King ADC Submission, page 11.

³⁰ ACCC Access Pricing Principles, page 21.

³¹ ACCC Access Pricing Principles, page 21.

47 The Commission has proposed this guideline:

“If the access price available to third parties is greater than the access provider’s price to its own vertically integrated operations, the Commission will need to be satisfied that the difference is consistent with the legislative criteria. One reason that may justify a higher price to competitors is differences in the economic costs of supply”³².

48 The available evidence, which is summarised in the Commission’s ADC Discussion Paper,³³ suggests that Telstra does not use an internal transfer price incorporating an explicit mark-up for the ADC. If Telstra is able to explain that it does use such an internal transfer price, it should. Otherwise, in AAPT’s submission, an inference is clearly available to the Commission that charging access seekers an ADC is not consistent with the legislative criteria.

49 The absence of an explicit charge in the nature of an ADC within Telstra reinforces the economic distortion associated with the ADC that has been already noted. The ADC imposes a cost on access seekers over and above the incremental cost of supplying a service. If Telstra does not charge itself an explicit internal transfer price, then the only economically sensible presumption is that its retail operations will recognize the true incremental cost of access services to Telstra and will compete in the relevant retail service markets on the basis of this incremental cost. As Telstra’s retail operations are based on incremental costs and do not include an equivalent ADC, Telstra is able to increase its rivals’ input costs above that level faced by its own retail units. This enables Telstra to raise rivals’ costs and impose a price squeeze on access seekers which would reduce the ability of these access seekers to effectively compete with Telstra’s retail units. Furthermore, pursuing a strategy of charging access seekers an ADC without charging its own retail units a similar contribution need not prevent Telstra from recovering the costs of providing basic access because Telstra will be able to recover these costs from market segments where it faces relatively little competition. In this way, Telstra is able to limit or constrain the capacity of access seekers to provide effective competition, and is potentially able to hinder the development of retail competition. The creation of this opportunity, given the incentives inherent in vertical integrated

³² ACCC Access Pricing Principles, page 25.

³³ ACCC ADC Discussion Paper, section 6.

telecommunication incumbents,³⁴ is inconsistent with the objective of promoting competition in markets for listed services.

50 Furthermore, this asymmetric treatment of any access deficit violates the principle of competitive neutrality Telstra itself propounds in its supporting submission.³⁵ As Gans and King point out, competitive neutrality has two key requirements:

*“1. All non-integrated downstream firms face the same marginal price for interconnection; and
2. The interconnection price for all non-integrated downstream firms is set equal to the true marginal cost of the access services.”³⁶*

Any access price in excess of the true incremental cost of access services to Telstra will, therefore, violate the principle of competitive neutrality. That the presence of an ADC violates competitive neutrality is also recognised by the Commission in its Draft Determination:

“Put simply, if the ADC were increased and this were fully reflected in retail prices, Telstra gains by the amount of the ADC increase per minute (across both wholesale and retail minutes) and the position of the access seekers is unchanged (higher access charge exactly matched by higher retail price). To the extent that any increase in the ADC is not passed through in retail prices, Telstra gains by the amount of the increase in the wholesale price and the increase in the retail prices while access seekers lose by the difference between the increase in the ADC and the (smaller) increase in retail prices.”³⁷

51 Finally, other things being equal, asymmetric treatment of access charges would alter the build/buy incentives of potential entrants in favour of a decision to build infrastructure. The result would be an inefficient race to invest in new infrastructure and inefficient bypass of existing infrastructure.

³⁴ The existence of an ability to limit or constrain effective competition in this way does not as a matter of economic theory mean that the ability will be used. However, an incentive will arise for the vertically integrated firm in circumstances where, as in telecommunications, there are barriers to entry at the level of the access seeker. Those barriers will give established access seekers a degree of market power and the potential to earn monopoly profits which would otherwise accrue to the vertically integrated firm. This incentive appears to have been recognised by the Productivity Commission (see *PC Telecommunications Report*, page 45). An added incentive can arise if, instead of focusing purely upon profit maximisation, the incumbent were seeking to maximise the size of its business or market share.

³⁵ Telstra, *Telstra's Submission in Support of its Undertakings*, 9 January 2003, Annexure A paragraph 15.

³⁶ J Gans and S King, *Competitive Neutrality in Interconnection Pricing*, 25 July 2003 (“*Gans and King Competitive Neutrality*”), page 3, attached as Annexure C.

³⁷ *ACCC Draft Determination*, page 42.

Efficient recovery of CAN costs

- 52 The ADC aims to achieve a contribution to CAN costs. In AAPT's submission, it must be fundamental to the ACCC's assessment to consider the economically most appropriate way of recovering CAN costs. This is directly relevant to both the efficient use of, and efficient investment in, the underlying infrastructure.
- 53 CAN costs are largely fixed costs - the costs incurred do not vary as the number or duration of calls increases. They do not therefore form part of the marginal cost of a call. More importantly in the context of interconnection pricing, they are common costs. They are costs incurred in the provision of a group of services. The costs of CAN maintenance, for example, will be common in this sense to the provision of both local and long distance calls. The costs would be incurred even if one or other of the services was not supplied. They do not therefore form part of the incremental cost of the service.
- 54 This has two implications for the ACCC's application of economic principles in assessing Telstra's undertakings: that recovery of these costs should be through a lump-sum charge and that regard should be had to demand responsiveness. AAPT addresses each of these implications in turn.

Lump-sum recovery

- 55 The most efficient way of recovering fixed costs is through fixed charges such as lump-sum payments. The benefit of lump-sum payments is that they are non-distortionary; a lump-sum payment made by a firm will not enter that firm's marginal cost. In the case of the recovery of any access deficit that is held to exist, the advantages of lump-sum payments are two-fold. First, since a lump-sum ADC will have no effect on an access seeker's marginal cost, a lump-sum payment will not introduce inefficient distortions to the price that access seekers will charge their customers for retail services. Second, a lump-sum ADC can be consistent with competitive neutrality since it need not cause access seekers to face access prices in excess of marginal cost. The inefficiency of recovering fixed and common costs through variable access charges has been recognised by the Commission in its Draft Determination, as seen in the Commission's description of the ADC as imposing "a significant distortion to competitive and efficient outcomes".³⁸

³⁸ ACCC Draft Determination, page 2.

56 Gans and King summarise the benefits of recovering the ADC through fixed charges as follows:

“The advantage of recovering access deficits in a similar manner to the USO is that it adds transparency and clarity to the system, decouples payments for fixed costs from distortions to marginal prices and potentially avoids distortions on competition that would otherwise result.”³⁹

57 In contrast, recovering an access deficit through variable charges – such as charges based on calls or call-minutes – will be inefficient and anti-competitive. First, it will introduce distortions to the price access seekers will charge retail customers, which will result in allocative inefficiency in the downstream market for telephony services. Second, it will breach the principle of competitive neutrality by causing access seekers to contribute to the access deficit in a manner that will affect their marginal cost, while the access deficit remains a fixed cost for Telstra, with no effect on marginal cost.

58 AAPT therefore submits that, to the extent that it is found necessary for Telstra to fund the costs of basic access by imposing an ADC on access seekers, the contribution made by access seekers should be a lump-sum payment.

Demand Responsiveness

59 Whether or not a lump-sum is used to cost recovery, the allocatively efficient way to recover fixed common costs across firms or across services is to have regard to the sensitivity of demand for the relevant retail product to changes in price. If demand for a product is relatively unresponsive to a change in price, then allocating more of the fixed common costs to that product will have relatively little effect on the quantity of that product purchased. The imposition of any mark-up on that product should therefore produce less distortion and less allocative inefficiency. In contrast, if demand for a product is highly responsive to changes in price, then an increase in the allocation of fixed common costs to that product, which leads to a rise in the product price, will lead to a relatively large change in the quantity of the product consumed and a relatively large distortion and large allocative inefficiency. The use of information about the demand responsiveness (in terms of both own and cross price elasticities of demand) is therefore a key element in efficiently allocating fixed and common costs.

60 Laffont and Tirole summarised the applicable principles in these terms:

³⁹ *Gans and King ADC Submission*, page 18.

*“The pricing of access should reflect conditions of demand in the retail market. Optimal third-degree price discrimination requires that the retail price be lower, the more elastic the demand in the retail market. Because competitive entrants charge purely cost-based retail prices and so are unable to price discriminate, this discrimination must be performed through the access charge. To do so requires that **the access charge be lower, the more elastic the demand in the final market.**”⁴⁰ (emphasis in original).*

61 These pricing principles suggest that the Commission should, in its approach to assessing the appropriateness of the ADC, seek to determine the extent to which the costs of the CAN are recovered from *all services* the provision of which utilise the CAN, and assess, on the basis of evidence or indications of relative demand responsiveness, the appropriate contribution that *each service* should make.⁴¹ In its Draft Determination the Commission has recognised the importance of demand elasticity in discussing the efficient use of telecommunications infrastructure:

“If, as is likely, this increase [in access prices] flowed through into higher retail prices for IDD, STD and FTM (including to their non-Telstra equivalents), the efficiency consequences would be substantial. This is because prices are already well above long-run costs of supply and because demands are quite elastic.”⁴²

62 Telstra does not take this approach in proposing there be an ADC imposed on access seekers. It departs from it in the following ways:

- (a) because Telstra’s PIE II model for costing PSTN services excludes many services which share the CAN with PSTN services (for example ADSL and certain data services are excluded from Annexure B to Telstra’s submission), the ADC calculated with the assistance of the model results in an allocatively inefficient way of funding the fixed and common costs of the CAN. The approach adopted by Telstra wrongly assumes that there are no other services supplied by Telstra

⁴⁰ J-J Laffont and J Tirole, *Competition in Telecommunications*, 2000, page 106. The principles underlying Ramsey-Boiteux pricing are outlined at page 61. The authors explain how pricing in accordance with these principles is business oriented in that, unconstrained, the goal of profit maximisation would similarly lead a firm to charge prices that are inversely proportional to the elasticities of demands for the services (pages 62 to 63). See also *Gans and King Evaluation*, Section 3.1.

⁴¹ Such an approach would be consistent with the direction reflected in government policy. As observed in *Gans and King Evaluation*, Section 3.1, the Federal Government’s approach to the phasing out of retail price controls is consistent with a Ramsey pricing approach to basic access. Because the demand for basic access is understood to be price inelastic relative to the demand for PSTN services, it would be economically more efficient to recover CAN costs from basic access charges than from interconnection. The Productivity Commission has described this approach as the first-best approach to dealing with the access deficit and as producing other economic welfare benefits, as well as making access pricing easier (see *PC Telecommunications Report*, page 414).

⁴² *ACCC Draft Determination*, page 36.

which utilise the CAN and which should contribute to its fixed and common costs⁴³; and

- (b) the allocation which does occur within PIE II for unrecovered PSTN CAN costs is undertaken on an equal⁴⁴ basis between services. No account is taken of retail demand responsiveness. The result can be expected to be a greater allocative distortion.

63 Of course, there are very significant practical difficulties with the application of principles identified above. Rarely is the data necessary for a full Ramsey-Boiteux pricing approach available. Nevertheless, it is recognised that there will often be significant information available in relation to the demand for both the specific service under investigation and the other services included in the allocation of fixed and common costs.

64 In AAPT's submission, the following information is relevant to an indirect assessment of demand responsiveness by the Commission:

- (a) Telstra uses the CAN in the supply of services into markets and market segments in which it faces relatively little competition and enjoys considerable market power. Telstra's market power has been described as very wide-ranging: "Telstra has overwhelming dominance across the telecommunications market and in almost every segment of that market."⁴⁵ There is evidence to suggest that Telstra enjoys market power in the following markets:

- (1) *Local telephony services*. The Productivity Commission, in its report on telecommunications competition regulation, concluded that Telstra possessed power in the market for local telephony services, and predicted

⁴³ *Gans and King Evaluation*, Section 4.2.

⁴⁴ See Telstra, *Telstra's Submission in Relation to the Methodology used for Deriving Prices Proposed in its Undertakings*, 9 January 2003 ("*Telstra's Undertakings Methodology*"), paragraph 12(f)(ii)(C).

⁴⁵ Allan Fels, "Competition in Telecommunications", Speech to ATUG, 6 March 2003 ("*Fels ATUG Speech*"). The ACCC came to the same conclusion regarding Telstra's market power in their submission to the Productivity Commission's inquiry into telecommunications competition regulation:

"Nevertheless, Telstra remains the only operator with a ubiquitous customer access network. Every other provider must interconnect to Telstra's network at some point in order to supply carriage services and ensure any-to-any connectivity. Despite substantial inroads into Telstra's share of industry revenue, Telstra's market power remains extensive."

See: ACCC, *Submission to the Productivity Commission Review of Telecommunications Specific Competition Regulation*, August 2000, page 57.

that Telstra would continue to enjoy this market power.⁴⁶ The Commission has also observed that there is little competition in the local call services market.⁴⁷

- (2) *Long distance telephony services.* The Productivity Commission has pointed out that the national long distance retail market is highly concentrated.⁴⁸ Again, the Commission appears to agree that there is evidence of ineffective competition in the national long distance retail market.⁴⁹
- (3) *International telephony services.* There is evidence of ineffective competition in the international telephony services market.⁵⁰
- (4) *Data.* The Productivity Commission recognises that Telstra maintains high market shares in the traditional areas of data management (such as leased lines and ISDN services).⁵¹ Dr Woodbridge, in a submission to the Productivity Commission, also argues that competition in the data market is likely to continue to be distorted.⁵²
- (5) *Mobile origination and termination.* As the Productivity Commission has noted, Telstra has a dominant position in the origination of fixed-to-mobile calls and the termination of mobile-to-fixed calls.⁵³ The Commission appears to agree that there is little competition for these services.⁵⁴

⁴⁶ *PC Telecommunications Report*, page 118.

⁴⁷ *Fels ABN AMRO Speech* and *Fels ATUG Speech*.

⁴⁸ *PC Telecommunications Report*, page 118. While the Productivity Commission expected that competition in the national long distance retail market would increase in future, evidence cited by Professor Fels in his *ABN AMRO Speech* and his *ATUG Speech* suggests that this has not so far been the case.

⁴⁹ *Fels ABN AMRO Speech* and *Fels ATUG Speech*.

⁵⁰ *Fels ABN AMRO Speech* and *Fels ATUG Speech*.

⁵¹ *PC Telecommunications Report*, page 140.

⁵² Graeme Woodbridge, "Competition in Telecommunications Markets under the Current Regulatory Regime in Australia", October 2000, pages 71-72:

"Barriers to network-based entry into the data market are significant. In many regional areas of Australia, the entry of an alternative network provider is uneconomic. In these and other areas, the major developments in competition are likely to occur through access-based entry. As in other telecommunications markets there is scope for the 'natural' barriers to network-based entry to 'spillover' to distort entry and competition in the contestable segments of the data market. This is likely to persist so long large (sic) segments of the wholesale services market remains(sic) uncontestable."

⁵³ *PC Telecommunications Report*, page 140:

It is not only the case that Telstra enjoys market power in these various markets, but Telstra is likely to continue to enjoy this market power:

“Recent analysis by the Commission shows that in the last year or so progress in achieving effectively-competitive telecommunications markets has slowed – there has been little change in the number and size of industry players and slowing price decreases.

The global downturn in telecommunications markets will have had a large impact. However, the industry structure – in particular Telstra’s network ownership and the integrated nature of its operations – is a key factor.”⁵⁵

- (b) Telstra enjoys several advantages as an incumbent the consequences of which afford it the ability to engage in product differentiation and the ability to charge higher retail prices than its new entrant competitors. These advantages include Telstra’s ownership of essential infrastructure, a large starting base of customers and close knowledge of these customers.⁵⁶ If anything, the indications are that there is justification in finding that services provided by Telstra are differentiated from, and face different own price elasticities of demand from, functionally similar retail services supplied by access seekers. The indications include the actual and perceived advantages of incumbency, including the advantages identified in AAPT’s ADC submission,⁵⁷ and

“With Telstra currently having a 95 per cent share of fixed local access services, it can also be expected to have close to this share of the following wholesale services:

- origination of fixed-to-fixed calls and fixed-to-mobile calls; and
- termination of fixed-to-fixed calls and mobile-to-fixed calls.”

⁵⁴ Fels ABN AMRO Speech:

“Unlike the market for other fixed line services – such as national and international long distance – there has been relatively little reduction in the final prices paid by consumers in recent years for fixed-to-mobile services. Further, and perhaps relatedly, there appears to be limited competition in terms of wholesale mobile termination.”

⁵⁵ Fels ABN AMRO Speech.

⁵⁶ Fels ABN AMRO Speech:

“Telstra’s market power derives, therefore, not merely from its market share but from its control of inputs essential to the provision of downstream services.

It will retain control over critical inputs for many services for the foreseeable future. It has had the advantages of an incumbent: a large starting share of the customer base and a close knowledge of these customers; deemed protection from competition before 1991 and from its position in the “managed duopoly” arrangement of 1991-97.”

⁵⁷ AAPT ADC Submission, page 6. A number of recent Ofcom studies have identified advantages of incumbency. See Conway Smith Rose, "The importance of brands in the UK telecoms market: qualitative report", September 2001, available at <http://www.ofcom.gov.uk/publications/research/2001/bran1101.htm>; Ofcom, *Consumer switching behaviour in the telecoms market*, August 2000, available at <http://www.ofcom.gov.uk/publications/research/swit0800.htm>; and Ofcom, *Consumer awareness and use of competition in the residential fixed line market*, May 2000, available at <http://www.ofcom.gov.uk/publications/research/choice00.htm>

(c) Telstra's own conduct - namely, the way in which it actually recovers the costs of basic access. As noted above, it is normally profitable to mark-up products in a manner consistent with economic theory and, if there is sufficient discretion, this will be observed in a multi-product firm.⁵⁸

65 The information available is strongly suggestive of Telstra being able to recover a contribution to its CAN costs from mark-ups on the retail price of many of its own services and that this is a more economically efficient way of recovering CAN costs (in the sense of producing less allocative inefficiency) than imposing a charge on access seekers which in turn would see a mark-up on their retail prices. There is also evidence that this is in fact what Telstra does.⁵⁹

Conclusion

66 In AAPT's submission, a consideration of the principles underlying the allocatively efficient recovery of CAN costs illustrates how, in the case of Telstra, the imposition of an ADC on access seekers is economically inefficient in comparison with other ways that Telstra can recover its CAN costs and which, on the indications available, Telstra in fact uses to recover its costs.

Calculation of the ADC

General comments

67 Telstra's method of calculating the ADC uses this formula:

PSTN CAN costs

Plus Retail costs attributable to PSTN CAN services

Less Maximum subscription revenue which could be earned by Telstra

Less USO revenue attributable to the PSTN received by Telstra.⁶⁰

⁵⁸ See the discussion in footnote 40 above.

⁵⁹ See *ACCC ADC Discussion Paper*, Section 4. See also footnote 40 above and the efficiency gain achievable by requiring Telstra to use its monopoly profits to reduce the charges imposed upon access seekers. The Productivity Commission has also recognised the economic justification for allocating a greater amount of common costs of the CAN to the incumbent if, by reason of market power, demand for its services is less elastic (see *PC Telecommunications Report*, page 649).

⁶⁰ *Telstra's Undertakings Methodology*, paragraph 12(f)(ii)(B).

- 68 This formula differs from that previously used by the Commission. As noted in its February Discussion Paper, the Commission has previously defined the relevant revenues as those deriving from line rentals and connection charges. Telstra's proposed formula here takes account of subscription charges, but it apparently does not take account of connection charges.⁶¹ No justification is offered for an exclusion and, in AAPT's submission, an exclusion should not be accepted.⁶²
- 69 Before turning to comment on the particular issues raised by the Commission in its discussion paper, this submission highlights some of the conceptual problems posed by, and reflected in, this formula.
- 70 As noted above, there is an important difference between the manner in which the proposed ADC and the USO scheme approach the funding of PSTN CAN costs. The USO scheme looks at the revenues earned by all products using the CAN. It treats basic access as a joint product. The proposed ADC, on the other hand, looks at line-related revenue. It treats basic access as a stand alone product.
- 71 As explained in the report forming Annexure B to this submission,⁶³ this distinction reveals a flaw in the argument underlying the proposed ADC – namely, that it ignores the benefits achieved by Telstra by reason of it being a vertically integrated firm and supplying telecommunications services to end-users. The implicit assumption is that Telstra is a mere infrastructure owner providing basic access to end users and wholesale access to providers of telecommunications services, but does not itself provide telecommunications services to end-users. This is a significant assumption – the fact that Telstra charges less than the retail cap indicates that it benefits from its vertical integration. It is inconsistent with the legislative criteria to ignore these benefits.
- 72 This problem with Telstra's formula for calculating the ADC can also be seen if it is assumed that the ADC is imposed upon access seekers for the first time or is increased. The report in Annexure B⁶⁴ shows how, where the demand for basic access and retail services is assumed to be price inelastic, a higher ADC will increase both Telstra's

⁶¹ Telstra stated in an email to AAPT dated 6 July 2003 – in response to a question posed by AAPT on 6 June 2003 – that the reference to subscription revenue in paragraph 12(f)(ii)(B) of *Telstra's Undertakings Methodology* refers to line rental, not to line rental and connection fees.

⁶² See also *Gans and King Evaluation*, Section 4.3.

⁶³ *Gans and King Evaluation*.

⁶⁴ *Gans and King Evaluation*, Section 4.5.

revenue as well as the revenues for all carriers. That would in turn lower the USO and, through Telstra's formula, lead to a further increase in the proposed ADC. That is a perverse outcome for a change intended to assist the funding of PSTN CAN costs and the creation of appropriate investment incentives. It is also contrary to the long-term interests of end-users (LTIE).

Local call surcharge

73 Telstra's methodology also involves the imposition of a local call surcharge. In essence, the argument is that the retail price regulation affecting local calls limits the ability of Telstra to recover PSTN CAN costs from the revenue achieved for the supply of that particular retail service. Accordingly:

*“Due to price caps on local calls, local calls and LCS can only recover costs of up to 17.51 cents per call. The UPCC are allocated to those calls up to that cap . . . The remaining UPCC are allocated on an equal basis over all other PSTN Services”.*⁶⁵

74 The Commission has not previously recognised such a contribution or surcharge.⁶⁶

75 Telstra's justification for this surcharge is similar in nature to its justification for the ADC generally:

*“In Telstra's view, the impact of regulatory constraints on the charging of local calls should be analysed no differently from that of regulatory constraints on access rentals . . . Because of the operation of the retail price caps, local calls cannot contribute their fair share . . . Consequently an adjustment to the contributions made by all other wholesale and retail services is necessitated by social policy”.*⁶⁷

76 In AAPT's submission, this justification suffers from the same fundamental flaw as does the justification for the ADC generally. It treats local calls services as a stand-alone product. In reality, local call services are not stand-alone products. Like basic access, local calls are normally provided by a firm which supplies other telecommunications services and are often bundled with other services. The proper economic analysis is set out in section 4.4 of Gans and King's report in Annexure B. Briefly, Gans and King find:

“ . . . the new hypothetical construct of a firm which just supplies CAN services and local call services is clearly arbitrary. Why stop there? At a minimum, if both

⁶⁵ Telstra's Undertakings Methodology, paragraph 12(f)(II)(C).

⁶⁶ ACCC, *A Report on the Assessment of Telstra's Undertaking for the Domestic PSTN Originating and Terminating Access Services*, July 2000, page 39.

⁶⁷ Telstra ADC Submission, paragraph 155.

the UPCC and the local call surcharge are consequences of the price caps imposed on Telstra, then a consistent approach would be to consider all of the price cap constraints on Telstra. . . .

Finally, why should we stop at just price capped services? Telstra provides a range of services, some of which are covered by price cap constraints and some of which are not covered by such constraints. To the extent that it operates at a profit overall, there seems to be little sense in which there are unrecovered costs.”⁶⁸

77 In any event, the Commission should not recognise this surcharge without appropriate evidence about the cost of local calls being made available to both the Commission and interest parties.

78 For these reasons, AAPT supports the Commission’s decision in its Draft Determination that there is no reason to deviate from its previous practice of not including a local call surcharge in access prices.⁶⁹

Comments on particular issues in the Commission’s undertaking Discussion Paper

79 AAPT makes the following comments on particular issues raised by the Commission in its Discussion Paper regarding Telstra’s undertakings:

- (a) AAPT agrees that, in calculating retail PSTN CAN revenue, the Commission should use the maximum possible subscription revenue rather than the actual subscription revenue. Otherwise, Telstra would be in a position to impose a price squeeze on access seekers by simply reducing its subscription revenue;
- (b) in relation to the recovery of the efficient PSTN CAN costs, AAPT submits the Commission should include, at a minimum, all net revenues associated with PSTN including PSTN access services, services which are bundled with basic access and other services which derive revenues associated with PSTN access services;⁷⁰
- (c) in relation to the allocation of the UPCC between calls and call end minutes, AAPT refers to the comments it made in its submission on the ADC.⁷¹ AAPT also endorses the Commission’s observations about Telstra’s basis for its proposed allocation;

⁶⁸ *Gans and King Evaluation*, pages 17-18.

⁶⁹ *ACCC Draft Determination*, page 44.

⁷⁰ *AAPT ADC Submission*, page 5.

- (d) in AAPT's submission, the weighted average cost of capital (**WACC**) applied to the CAN assets should be lower than the WACC used for estimating call conveyance costs due to the lower risk associated with the CAN (and if the net costs of basic access are to be recovered through a combination of the USO scheme and an ADC imposed on access seekers, the CAN would be risk-free); and
- (e) in paragraph 43 of its supporting submission, Telstra reserves the ability to seek a modification of the amount of USO revenue taken into account in calculating the ADC. Telstra refers to an adjustment for the purpose of Telstra recovering its contributions towards the PSTN-related USO costs from both wholesale and retail prices. The Commission should not implicitly acknowledge Telstra's suggestion without the point being the subject of proper consultation, including a proposed form of adjustment, detailed justification from Telstra and an opportunity for industry participants to comment. AAPT reserves its right to comment on any such adjustment if and when it is formally proposed by Telstra.

Rate rebalancing and the phase out of the ADC

80 AAPT submits that it is relevant to the Commission's assessment of Telstra's undertakings and its determination of model price terms that stated government policy involves the ADC being phased out.

81 In a determination made in 2002, *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2002*, Richard Alston, Minister for Communications, Information Technology and the Arts, increased the price-cap on Telstra's line rentals from CPI+0 to CPI+4.

82 The stated reason for this increase in the price-cap was the need to redress Telstra's inefficient pricing. The *Regulation Impact Statement* preceding the determination stated:

*"A number of studies in recent years have concluded that the structure of Telstra's prices is inefficient. The more competitive services, including STD and IDD services, are over-priced, while line rental charges (connections and line rentals) are under-priced, compared with efficient (Ramsey) prices, based on underlying supply and demand conditions."*⁷²

⁷¹ AAPT ADC Submission, pages 5 and 6.

⁷² DCITA, *Telstra Carrier Charges—Price Control Arrangements, Notification and Disallowance Determination No. 1 of 2002: Regulation Impact Statement* ("DCITA Impact Statement").

- 83 By lifting the line rental price cap, these market distortions could be corrected, and the access deficit removed. The Department of Communications, Information Technology and the Arts (**DCITA**) consulted stakeholders on the appropriate glide-path for transition to cost-based line rentals. DCITA determined that a 4-year rebalancing period provided a reasonable balance between timeliness and the need to avoid “rate shock”. DCITA concluded that line rentals could be rebalanced in 4 years with a price cap of CPI+4.
- 84 Consequently, for the three years of the current price control period – up to 30 June 2005 – the price cap was increased by CPI+4. This cap is to be reviewed in 2005 – but, on current expectations, an extension of this price cap until 30 June 2006 will achieve full rebalancing and the removal of any access deficit.

The long-term interests of end-users

- 85 It is clear from comments made by Senator Alston, and from DCITA’s *Regulation Impact Statement*, that the aim of promoting the LTIE was a significant factor in the decision to phase out the ADC. The phasing out of the ADC will contribute to the LTIE by reducing the price of telephone calls and by promoting competition.
- 86 The price of telephone calls will fall because the phasing out of the ADC will reduce interconnection fees. The *Regulation Impact Statement* states:

“In assessing charges for interconnection to Telstra’s network by other carriers, the ACCC adds an access deficit contribution (ADC) . . . [W]ithout an ADC, the appropriate interconnection charge would have been much lower at around 0.84 cents per minute. Removal of the access deficit will therefore mean reductions in the prices of telephone calls.”⁷³

- 87 In a speech to the Australian Telecommunications Users Group, Senator Alston made the same observation:

“In effect, call prices have been kept artificially high in order to recoup the losses on line rental otherwise known as the ‘access deficit’. Under the price control arrangements the access deficit will be eliminated over about four years . . .”⁷⁴

- 88 A removal of the ADC in this way would also promote competition by lowering barriers to entry to the downstream market. A media release from Senator Alston regarding amendments to the price caps stated:

⁷³ DCITA *Impact Statement*.

⁷⁴ Senator Richard Alston, “Keynote Address to Australian Telecommunications Users Group Conference”, 5 March 2003, page 4 of transcript.

“The new price controls will enable the removal of a major impediment to competition in the sector – the ‘access deficit’ – which has inflated charges for interconnection to Telstra’s network and impeded the provision of even lower priced offerings to consumers.”⁷⁵

Long-term investment incentives

- 89 That the price cap relevant to the ADC is planned to be phased out within three years is relevant to the statutory objective of encouraging economically efficient investment in infrastructure.⁷⁶ Specifically, because the access deficit is envisaged to be non-existent within 3 years, it cannot be the case that a decision by the Commission rejecting an ADC during the period of the current undertakings would deter Telstra’s incentives to invest in infrastructure.
- 90 Decisions to invest in infrastructure are long-term decisions. This is particularly true of long-lived infrastructure such as the CAN. When determining whether or not to invest in the CAN, Telstra will consider the expected returns from the investment over the entire life of the infrastructure – not just over the next three years. Consequentially, a decision to prevent Telstra from levying an ADC, while it may have some limited impact on the payoffs that Telstra will receive in the next three years as price controls are relaxed, will have negligible effect on the total expected payoff from investment.
- 91 That this is the case is only reinforced by the fact that, regardless of the Commission’s decision regarding the ADC, Telstra is already aware, and has been aware for over a year, that any revenue from its investments that is associated with an ADC is already in the process of being phased out. As a result, any revenue associated with an ADC is unlikely to have played a determining role in any of Telstra’s investment decisions, so that a decision by the Commission rejecting an ADC cannot reasonably be considered as likely to disrupt these decisions.

The legislative criteria

- 92 The Commission seeks to promote the LTIE in determining model terms and conditions under section 152AQB of the Act. Section 152AB of the Act provides that the Commission, in considering the LTIE, must consider the extent to which declaration will result in the achievement of the following objectives:

⁷⁵ Senator Richard Alston, “Consumers to benefit from Telstra price caps”, Media Release on 22 April 2002.

⁷⁶ Section 152AB of the Act.

- (a) the promotion of competition in markets for listed services;
- (b) the achievement of any-to-any connectivity in relation to carriage services that involve communication between end-users; and
- (c) the encouragement of economically efficient use of, and economically efficient investment in, the infrastructure by which listed services are supplied.

93 In addition, the Commission will also have regard to the reasonableness criteria that are contained in section 152AH of the Act. In determining whether terms and conditions are reasonable, the following matters must be considered:

- (a) whether the terms and conditions promote the LTIE of carriage services or of services supplied by means of carriage services;
- (b) the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or provider's investment in facilities used to supply the declared service concerned;
- (c) the interests of persons who have rights to use the declared service concerned;
- (d) the direct cost of providing access to the declared service concerned;
- (e) the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility; and
- (f) the economically-efficient operation of a carriage service, a telecommunications network or a facility.

94 In accordance with the Commission's Draft Determination,⁷⁷ this submission focuses on the following criteria:

- (a) achieving efficient use of telecommunications infrastructure;
- (b) achieving more efficient investment in telecommunications infrastructure;
- (c) having regard to the legitimate commercial interests of access providers; and
- (d) the promotion of competition.

⁷⁷ *ACCC Draft Determination*, pages 35-36.

95 To this end, in this section AAPT assesses the extent to which the exclusion of an ADC from access charges contributes to the achievement of each these objectives. Briefly, AAPT's conclusions regarding the achievement of the objectives are that:

- (a) the removal of the ADC will move access prices closer to the cost of providing access and thereby promote efficient use of infrastructure;
- (b) Telstra will have appropriate incentives to invest in infrastructure without the ADC;
- (c) Telstra will earn an appropriate return on its investments without the ADC; and
- (d) that the removal of the ADC will bring access prices closer to the marginal cost of providing access and thereby promote competition in the provision of relevant services to end-users and competitive neutrality.

Efficient use of infrastructure

96 The Commission notes in its Draft Determination that it interprets efficient use of infrastructure in terms of moving prices closer to underlying costs.⁷⁸

97 Since the ADC in no way constitutes a direct cost of providing access, it is clear that the removal of an ADC from access prices will move access prices closer to the cost of providing access. In fact, as recognised by Gans and King, the ADC relates largely to fixed network costs, which do not affect the marginal cost of providing access.⁷⁹ Consequently, the inclusion of an ADC in access prices will move the marginal access price away from the marginal access cost.

98 Since the removal of an ADC will move prices closer to costs, it will contribute to efficient use of infrastructure. This is recognised by the Commission in its Draft Determination. For instance, in its consideration of a faster phasing out of the ADC, the Commission finds that the ADC creates a gap between cost and price:

“There would continue to be a gap between the retail price and cost to the economy of producing IDD, STD and FTM calls (as higher access prices flowed through to retail prices), however, this gap would be reduced over time and be removed completely by 2006-07.”⁸⁰

⁷⁸ ACCC Draft Determination, page 36.

⁷⁹ Gans and King Competitive Neutrality Paper, page 16.

⁸⁰ ACCC Draft Determination, page 49.

99 AAPT supports the Commission's finding that there will continue to be a gap between prices and costs as long as an ADC is included in access prices. For this reason AAPT submits that the efficient use of infrastructure will best be promoted by the immediate exclusion of the ADC from access prices. A gradual phasing out of the ADC will only delay efficiency gains.

Efficient investment in infrastructure

100 As the Commission notes in its Draft Determination, the criteria of efficient investment in infrastructure has been interpreted in terms of incentives for Telstra to make economically-justifiable investments in PSTN and to ensure that access seekers face appropriate build/buy decisions.⁸¹ AAPT will consider each of these two issues.

101 Considering Telstra's incentives to make economically-justifiable investments, AAPT submits that the exclusion of an ADC will not be distortionary. The Commission recommends in its Draft Determination that incentives to invest should be assessed by treating basic access as a joint product, not a stand-alone product:

“To the extent that there are concerns with the financial position of particular services, this would appear to overlook the fact that the entire PSTN is required to produce any particular call service. Thus, in the Commission's view, it would not be prudent to abandon the entire PSTN just because one part of it was not profitable or not as profitable as some other parts. Only if the entire PSTN were in deficit would abandonment be a consideration.”⁸²

In other words, incentives to invest in the PSTN should be assessed on the basis of the profitability of the entire PSTN, not just the profitability of providing basic access. As discussed extensively above, AAPT supports this view.

102 AAPT further submits that considering investment incentives from this perspective reveals that the removal of the ADC from access prices will not impair Telstra's incentives to make economically-justifiable investments. The following are reasons that Telstra's incentives to invest will not be inappropriately diminished:

- (a) as recognised in the Commission's ADC Discussion Paper, and as discussed above, Telstra's investment in providing basic access is profitable due to the returns that Telstra earns on services using basic access. This will be the case regardless of whether an ADC is included in access prices. In short, it is the

⁸¹ ACCC Draft Determination, page 36.

⁸² ACCC Draft Determination, page 38.

profitability of services that require basic access, rather than the level of access prices, that drives Telstra's investment in basic access. Gans and King state that:

“Certainly, if Telstra were to go bankrupt, this would create problems for the telecommunications industry and may end up harming customers. Nonetheless, it is our understanding that the UPCC level is currently less than Telstra's profit levels and so this seems an unlikely possibility. Indeed, Telstra do not even say that they will divest the CAN services if a UPCC contribution is not allowed; something that would surely be considered before a complete shut down in its operations.”⁸³;

- (b) even if it were the case that Telstra did not earn sufficient profit on the provision of services that use basic access to have adequate incentives to invest in basic access, the USO scheme ensures that Telstra's investment incentives will be adequate. Essentially, the USO scheme ensures that Telstra will be adequately compensated for its investments in basic access. Gans and King state that:

“. . . it has been argued that Telstra would have little if any incentive to invest in the CAN if it did not receive an access deficit contribution. However, Telstra's universal service obligations require such investments and compensate Telstra for them through the USO fund. Indeed, as that fund is cost-based, if anything it may provide too much rather than too little incentive to maintain and expand the CAN.”⁸⁴;

- (c) Telstra's incentives to invest in the provision of basic access are based on the long-term returns on the investment. Given the government's stated policy of phasing out the ADC by 2006-07, the ADC will already have little effect on Telstra's long-term investment decisions. Any decision the Commission makes to phase out the ADC earlier than 2006-07 will also, therefore, have little effect on Telstra's investment decisions. Gans and King state that:

“Investments in the CAN would be considered in terms of their long-term profitability on a time horizon well beyond this date. As such, short-term losses (if any) that Telstra has on the CAN will not be relevant for important longer-term investment decisions.”⁸⁵

- 103 For these reasons, AAPT supports the Commission's finding that there is no “actual or imminent crisis in PSTN investment”,⁸⁶ and that a “reduction in the ADC over a shorter time-frame would not harm ongoing investment in the PSTN”.⁸⁷

⁸³ Gans and King Evaluation, page 20.

⁸⁴ Gans and King ADC Submission, page 11.

⁸⁵ Gans and King Evaluation, page 20.

⁸⁶ ACCC Draft Determination, page 39.

- 104 In fact, AAPT submits that, if anything, the continued inclusion of an ADC will disrupt investment incentives. The reason is that, because of the overall profitability to Telstra of the provision of basic access, and the operation of the USO scheme, the inclusion of an ADC in access prices provides Telstra with an excessive return on its investments. If anything, this will encourage Telstra to over invest in the provision of basic access.
- 105 Considering the build/buy decisions of access seekers, AAPT supports the Commission's view that any variation of access prices from the TSLRIC level will be distortionary. The Commission states that:

*"In the Commission's view, access seekers should be faced with an access price reflecting the TSLRIC of providing access on a forward-looking basis. Placing an ADC on top of this would appear to take the access price away from this ideal, providing an artificial stimulus to build rather than buy."*⁸⁸

- 106 This distortion will exist for as long as an ADC is included in access prices, and consequently, in order to promote efficient build/buy decisions, the ADC should be immediately removed from access prices. In this regard AAPT notes the Commission's already distortionary decision to not include the equivalent of the ADC in the PSTN OTA rates for non-dominant networks. The continuation of the ADC for Telstra would result in a continuation of this distortion.
- 107 For these reasons – because the exclusion of the ADC from access prices will not deter Telstra from efficiently investing and because the inclusion of the ADC in access prices will distort access seekers' build/buy decisions – AAPT submits that efficient investment in infrastructure will best be promoted by the removal of the ADC. Furthermore, the gradual phasing out of the ADC will only delay the achievement of efficient investment incentives and, for this reason, does not contribute to the promotion of efficient investment as well as the immediate removal of the ADC.

Telstra's legitimate commercial interests

- 108 The Commission notes in its Draft Determination that in considering Telstra's legitimate commercial interests the Commission will take the perspective of the whole of Telstra's activities:

⁸⁷ ACCC Draft Determination, page 49.

⁸⁸ ACCC Draft Determination, page 38.

*“Access pricing must have regard to Telstra’s legitimate commercial interests. This is interpreted as allowing Telstra to cover its efficient costs from the totality of its retail and wholesale pricing . . .”*⁸⁹

This is in accordance with AAPT’s approach, as discussed in this submission.

109 AAPT submits that considering Telstra’s legitimate commercial interests as a provider of basic access from the perspective of basic access as part of joint telephony products reveals that the removal of the ADC will not impair Telstra’s legitimate commercial interests. Telstra’s legitimate commercial interests are protected because the removal of the ADC does not prevent Telstra earning a reasonable return on those telephony services associated with basic access. In fact, as AAPT argues in this submission, Telstra’s commercial interests are precisely to earn an adequate return on the PSTN network as a whole, rather than on any particular service the provision of which requires the network, such as basic access. Furthermore, even in the absence of the ADC, the USO scheme provides adequate protection for Telstra’s legitimate commercial interests in those ESAs in which the network as a whole does not require an adequate return.

110 The Commission’s only concern for Telstra’s legitimate commercial interests seems to be that the immediate removal of the ADC will disrupt Telstra’s business decisions:

*“. . . the Commission recognises that any abrupt or immediate removal of the ADC from access charges may result in a burden to Telstra to the extent that it may have made various business decisions based partly on the assumption that it will continue to receive the ADC, if only in the short-term. For example, any abrupt change to the ADC may not be consistent with facilitating a regulatory environment in which long-term decisions can be made with relative certainty around the pricing parameters which should be used.”*⁹⁰

111 AAPT submits that the Commission need not be concerned with Telstra’s business decisions when deciding the optimal time for removal of the ADC. There are two reasons for this. First, as discussed above, the ADC is to be phased out by 2006-07 regardless of the Commission’s decision, so that Telstra’s long-term decisions will not be significantly affected by the immediate removal of the ADC. Secondly, as discussed above, the Commission’s previous inclusion of an ADC in access prices was never stated to be a final decision. Consequently, Telstra’s business decisions should rationally have reflected the possibility that the ADC could be removed from access prices. This possibility was abundantly clear to Telstra prior to the Commission’s release in February 2003 of its

⁸⁹ ACCC Draft Determination, page 39.

⁹⁰ ACCC Draft Determination, page 41.

discussion paper on the ADC. For the Commission to now preserve the ADC up until the ADC would have been phased out anyway is to provide to Telstra a guarantee that Telstra did not previously have. It is this guarantee – and not the removal of the ADC – that will distort Telstra's business decisions. In addition, and as discussed below, the preservation of the ADC will substantially harm access seekers, competition and efficiency.

Promotion of competition

112 As the Commission has recognised in its Draft Determination,⁹¹ the promotion of competition is closely related to the issue of competitive neutrality. It is AAPT's submission that any access charges that are not competitively neutral will impede competition. Furthermore, AAPT submits that the inclusion of an ADC in access charges will lead to access prices that are not competitively neutral.

113 That this is the case has been argued by Gans and King in their report on competitive neutrality which is Annexure C to this submission.⁹² In this report, Gans and King derive two conditions that are necessary for competitive neutrality of access prices:

*“1. All non-integrated downstream firms face the same marginal price for interconnection; and
2. The interconnection price for all non-integrated downstream firms is set equal to the true marginal cost of the access services.”⁹³*

114 On the basis of these criteria, Gans and King conclude that the inclusion of an ADC in access prices breaches the requirements for competitive neutrality:

“The ADC relates to what are largely fixed network costs. Our analysis in this report shows that marginal access prices must be set equal to marginal access prices for competitive neutrality. This does not prevent access costs involving fixed fees or the recovery of the ADC through some industry based levy such as the USO scheme. But it does mean that fixed costs associated with Telstra's upstream operations must not be included as variable access charges if competitive neutrality is to be maintained.”⁹⁴

115 Furthermore, in a report – Annexure D to this submission – that examines Attachment 14 of Telstra's ADC Submission, Gans finds that, contrary to Telstra's model, the removal

⁹¹ *ACCC Draft Determination*, pages 41-42. Note that these criteria are applicable in all instances in which the demand curve is downward sloping.

⁹² *Gans and King Competitive Neutrality Paper*.

⁹³ *Gans and King Competitive Neutrality Paper*, page 3.

⁹⁴ *Gans and King Competitive Neutrality Paper*, page 16.

of the ADC leads to lower retail prices and higher consumer welfare.⁹⁵ This outcome is consistent with the finding that the removal of the ADC leads to the promotion of competition.

116 For this reason, AAPT suggests that any access prices that include an ADC cannot be competitively neutral. This does not necessarily mean that the removal of an ADC from access prices will lead to competitively neutral access prices. After all, even without the ADC, access prices may still be in excess of marginal cost. However, with the removal of the ADC, access prices will fall towards marginal cost and will become more closely aligned to competitively neutral access prices.

117 It is also important to note that AAPT does not necessarily propose that access prices should be set at marginal cost. AAPT recognises that such access prices are likely to breach the other legislative criteria, particularly the promotion of efficient investment in infrastructure. However, AAPT does submit that the removal of the ADC will promote the legislative criterion of competitive neutrality.

118 That removal of the ADC promotes competition is recognised by the Commission in its Draft Determination:

“This said, competition and other efficiency outcomes will likely be promoted by removing the ADC from PSTN access charges more quickly or even immediately.”⁹⁶

119 However, elsewhere in its Draft Determination the Commission seems concerned that competitive neutrality may be breached by the immediate removal of the ADC. The Commission states:

“Competitive neutrality may not be assisted by the earlier removal of the ADC, particularly where some access seekers are currently out of contract and others are stranded on current contracts, however, again the 3-4 year phase-out period being contemplated under this approach suggests this is unlikely to be an issue.”⁹⁷

120 The Commission’s concern seems entirely related to the timing of the removal of the ADC. Specifically, the Commission seems concerned that, with the immediate removal of the ADC, competitive neutrality as between access seekers would be impaired since

⁹⁵ J Gans, *Reducing PSTN Interconnection Charges Will Lower Retail Telecommunications Prices: A Response to Telstra’s Submission*, 23 June 2003, attached as Annexure D.

⁹⁶ ACCC Draft Determination, pages 49-50.

⁹⁷ ACCC Draft Determination, page 49.

those access seekers that have entered into long-term contracts negotiated on the understanding that the inclusion of an ADC in access prices constituted Commission policy would be disadvantaged as compared to access seekers that would be able to negotiate access charges following the Commission's removal of the ADC from model price terms.

- 121 AAPT fails to understand the Commission's reasoning on this point. In AAPT's submission, the Commission can promote competition in one of two ways: by immediately removing the ADC or by gradually phasing out the ADC. The difference between these approaches can be understood if we assume that there are two access seekers. Access seeker A does not have an existing contract with Telstra and access seeker B has a contract, with prices negotiated to include an ADC, which will last say for three years.
- 122 With the immediate removal of the ADC, access seeker A will immediately be able to negotiate access prices that more closely resemble competitively neutral access prices and, for this reason, will be able to exert a greater competitive influence in the market. Access seeker B, on the other hand, will only be able to exert a more competitive influence on the market once it re-negotiates its contract in three years.
- 123 With the phasing out of the ADC, access seeker A will only be able to exert a more competitive influence on the market as the ADC is gradually phased out. Access seeker B, on the other hand, will again only be able to exert a more competitive influence on the market once it re-negotiates its contract in three years.
- 124 The difference between these two approaches, clearly, is that with the immediate removal of the ADC access seeker A is able to exert a stronger competitive influence more quickly. In AAPT's submission this clearly does more to promote competition than the gradual phasing out of the ADC. As the above example makes clear, to gradually phase out the ADC merely delays the promotion of competition, presumably in the interests of protecting access seeker B from increased competition. This is inappropriate because to delay the promotion of competition in the interests of protecting a particular access seeker (or a particular class of access seekers) is to protect competitors not competition. This is clearly against the objectives of the Act.⁹⁸

⁹⁸ See, for example, section 1.2.

International Comparisons

125 In its February 2003 submission on the need for an ADC, Telstra referred to the position in other countries in support of including a charge in the nature of an ADC. Annexure A to this submission contains an assessment of the extent to which the jurisdictions to which Telstra has referred in fact offer such support. AAPT's conclusions are that none of the jurisdictions include an equivalent of an ADC in their interconnection charges and several of the regulators are highly critical of the use of ADCs.

Comments on the Commission's proposed phasing out of the ADC

126 The approach outlined by the Commission in the draft determination on model price terms reflects a basic rejection of the premises underlying the ADC. Specifically, the following has been found by the Commission with the benefit of public consultation supported by a detailed discussion paper:

- (a) that Telstra (more than) covers its efficient costs of supplying the relevant services;⁹⁹
- (b) that it appears:

“ . . . that the level of Telstra's profitability with or without the ADC . . . would be sufficient to provide it with the incentive to invest in the maintenance of the productive capacity of the PSTN. Apparent rates of return from the PSTN are well in excess of Telstra's weighted average cost of capital.”¹⁰⁰;
- (c) that the ADC:

“ . . . cannot be competitively neutral”¹⁰¹; and
- (d) that the ADC has a negative impact on competition in the downstream markets for IDD, STD and FTM calls¹⁰² and its impact on the efficiency and competition objectives is having a distortionary effect.¹⁰³

⁹⁹ ACCC Draft Determination, section 8.3.3.

¹⁰⁰ ACCC Draft Determination, page 36.

¹⁰¹ ACCC Draft Determination, page 42.

¹⁰² ACCC Draft Determination, page 46.

¹⁰³ ACCC Draft Determination, page 48.

127 Despite these findings, the Commission has indicated a preference for a three-year phase out of the ADC. That preference appears to be driven by a desire to facilitate regulatory stability.¹⁰⁴

128 To some extent, AAPT takes issue with the Commission's preferred course. In short, it endorses the Commission's rejection of the ADC as a matter of principle, but believes that a shorter phase out period is justified. There are several inter-related reasons for adopting that position, each of which is developed below.

Elimination of the ADC will not threaten profitability or investment incentives

129 As the Commission has observed, Telstra's PSTN profitability cannot be threatened by the elimination of the ADC. It is clear that the PSTN is highly profitable and would continue to be highly profitable absent the ADC being included in access charges.

130 The Commission is not the only party reaching the view that the PSTN is highly profitable. The Productivity Commission reached a similar view after its inquiry, which included extensive public consultation. Telstra itself publicly states the view.

131 As the PSTN clearly earns more than a reasonable commercial return with or without the ADC, the elimination of the ADC cannot threaten economically efficient investment in the PSTN.

The arguments against an ADC are compelling

132 In AAPT's view, the arguments against an ADC are sufficiently strong as to regard the inclusion of an ADC in PSTN access charges as indefensible. The Commission itself has always been mindful of distortions created by the ADC and has now confirmed not only the validity of those concerns but also that the grounds proffered by Telstra for the inclusion of ADC (and assumed by the Commission in the past to be good grounds) are in truth unsound.

133 The position is considerably more serious than the ADC lacking sufficient justification to be included in regulated access prices. It is shown that the ADC is both without justification and directly harmful to the efficiency and competition objectives of Part XIC of the Act. It is also a very significant charge, representing some 45% of access prices.

Stranded access seekers do not justify a market-wide phasing out

¹⁰⁴ ACCC Draft Determination, pages 17 and 41.

134 The Commission has indicated concern about access seekers on long-term contracts, the access prices in which may reflect an ADC. The concern is that:

“ . . . some access seekers who have current contracts extending to at least 2004/2005 may find themselves ‘stranded’ at significantly higher rates if immediate changes to the ADC were made.”¹⁰⁵

135 In part, this might be justified by reference to a consideration of the interests of persons who have rights to use the declared service.¹⁰⁶ The Commission also sees it as potentially relevant to the achievement or promotion of competitive neutrality.¹⁰⁷

136 There are problems with this analysis. It proceeds on the assumptions that:

- (a) there are in fact long-term contracts for access seekers, the terms of which extend well into the future;
- (b) the access prices in those contracts reflect or include an ADC; and
- (c) the terms of those contracts are such that no review of access prices can occur in circumstances where the ADC is eliminated in the model price terms.

137 There is no indication in the Commission’s Draft Determination of any evidence supporting these factual assumptions. It appears to be simply presumed. It also appears that the Commission has not taken basic steps to check upon these factual assumptions. AAPT is not suggesting that it should in this context; rather, it suggests that, more appropriately, it should leave circumstances of that nature to be addressed in respect of private arbitrations or undertaking assessments. As the draft determination itself acknowledges, the model price terms are intended to provide a general guide only. Arbitrations and access undertakings provide the contexts for more specific considerations such as these.

138 The analysis also assumes that, if the parties have an existing contract, they will not or cannot seek arbitration under Division 8 of Part XIC. This is not necessarily correct. All that is required for arbitration to be available is the existence of a dispute about access.¹⁰⁸ Part XIC itself acknowledges that access seekers with a contract may notify disputes –

¹⁰⁵ ACCC Draft Determination, page 48.

¹⁰⁶ See paragraphs 152 AH(1)(c) and 152 CR(1)(d).

¹⁰⁷ ACCC Draft Determination, page 46.

¹⁰⁸ Section 152 CM.

the grounds for terminating arbitrations include a consideration by the Commission that access should continue to be governed by “an existing contract”.¹⁰⁹

Stable regulatory environment does not require a lengthy phase out period

139 The Commission is rightly conscious of the general desirability of a stable regulatory environment. There are, however, somewhat exceptional circumstances applying to Telstra’s continuing imposition of an ADC:

(a) the Commission has indicated a concern that:

“... any abrupt or immediate removal of the ADC from access charges may result in a burden to Telstra to the extent that it may have made various business decisions based partly on the assumption that it will continue to receive an ADC, if only in the short term.”¹¹⁰

Again, there does not appear to be any evidentiary basis for this proposition. In fact, this proposition appears to be contrary to the available evidence which the Draft Determination itself outlined in sections 8.3.2 and 8.3.3. Moreover, Telstra has been on notice since April 2002 of the foreshadowed change in government policy which would, itself, see the ultimate elimination of the ADC. If there is evidence to support the presumption made by the Commission, Telstra should adduce it and, subject to general confidentiality concerns, make it available for scrutiny pursuant to the public consultation process. That has not occurred. In these circumstances, it is inappropriate for the Commission to proceed to support a phase out period on the basis of this presumption;

(b) even if Telstra had relied upon or assumed a continuation of the ADC in its planning, the reasonableness of doing so is questionable. The imposition of an ADC has always been highly contentious. AAPT and others have consistently and vigorously argued against it, essentially on the grounds now accepted by the Commission. The Commission itself acknowledges in the draft determination that:

“...the Commission has always maintained that there is a possibility that the AD might not exist if examined on an aggregate or PSTN or fixed network level.”¹¹¹

¹⁰⁹ Paragraph 152 CS(1)(d).

¹¹⁰ ACCC Draft Determination, page 41.

¹¹¹ ACCC Draft Determination, page 51.

Previous decisions by the Commission clearly indicate that it proceeded on certain premises and assumptions which it has now concluded are unsound;¹¹²

- (c) implicit in the Commission's consideration of a stable regulatory environment is the assumption that its previous adjudication of this issue was well founded and correct and that, somehow, the regulatory environment is now about to change. With respect to the Commission, that is a flawed perception. The regulatory environment is not about to relevantly change. The Commission has simply concluded that a view, which it had previously indicated on an explicitly tentative and presumptive basis, is not well founded and is incorrect. The Commission's view did not in any sense represent "the law"; nor was it in any sense the final authoritative word on the issue.

Consider the position if the PSTN arbitrations involving Telstra, AAPT and Primus before the Australian Competition Tribunal (ACT) had proceeded to final hearing and determinations in 2002 with the ADC being excluded from access prices. At the very least, that would have seen the ADC eliminated for the access seekers involved as and from July 1999. On the view of the backdating power taken by the ACT, it would have seen the ADC eliminated for AAPT as and from July 1998. There would not have been any notion of gradual phasing out; the elimination of the ADC would have been retrospective.¹¹³

Similarly, if an access seeker were to notify a dispute now and in an arbitration it were found that the ADC was unsupported, it should be possible to achieve retrospective elimination of the ADC under section 152DNA of the Act to the date negotiations commenced with a view to the parties agreeing on the PSTN wholesale pricing;

- (d) the Commission's analysis has revealed the anti-competitive strategy behind the imposition of the ADC – to earn rents in the short-term and to contribute to entry barriers by artificially raising rivals' costs, thereby frustrating competition and efficiency and delivering longer term rents. The implementation of the strategy

¹¹² See, for example, ACCC *Report on the assessment of Telstra's undertaking for the domestic PSTN originating and terminating services*, July 2000, at pages 37 and 42.

¹¹³ Telstra Corporation Ltd [2001] ACompT 4.

has been aided by significant information asymmetry and regulatory gaming by Telstra.

A strategy found to be so clearly anti-competitive and without merit should not be rewarded with a generous phase-out. That would send the wrong signals; and

- (e) the nature of the Commission's findings give rise to an enforcement issue – is it appropriate for the Commission to issue a Competition Notice under Part XIB of the Act in respect of the continued imposition of the ADC by Telstra given its effect or likely effect on competition in telecommunications markets? That issue arises because of the generous phase-out proposed by the Commission. It would be unsatisfactory, and may itself give rise to competitive neutrality problems, if the Commission were to find itself faced with requests for enforcement action under Part XIB where the primary cause of the problem was a combination of its strong findings against the imposition of an ADC and a generous phase-out period.

The theory of deregulatory takings

140 One way of looking at the question of whether the ADC should be gradually phased out or immediately removed is from the perspective of the theory of deregulatory takings. The principal supporters of the theory of deregulatory takings – J. Gregory Sidak and Daniel Spulber¹¹⁴ – suggest that there are circumstances in which regulatory change, including the deregulation of the telephony industry, may constitute a breach of an implicit regulatory contract. Such a breach is likely to impose costs on incumbent firms who should, therefore, be compensated.

141 On first glance, this theory of deregulatory takings may appear to provide support for the Commission's decision to gradually phase out rather than immediately remove the ADC – the gradual phase out provides Telstra with time to adjust, which might be regarded as a form of compensation for the regulatory change. However, in AAPT's submission, the removal of the ADC cannot be regarded as a breach of any regulatory contract and, for this reason, there is no necessity to provide any compensation to Telstra. Furthermore, AAPT submits that even Sidak and Spulber, strong advocates of the theory of

¹¹⁴ See, for example: J Sidak and D Spulber, (1996) "Deregulatory Takings and Breach of the Regulatory Contract", 71(4) *New York University Law Review* 851; J Sidak and D Spulber (1997) "Givings, Takings and the Fallacy of Forward-Looking Costs", 72 *New York University Law Review* 1068.

deregulatory takings, would recognise that the removal of the ADC does not constitute a breach of a regulatory contract. Opponents of the theory of deregulatory takings – who include Oliver Williamson, William Baumol and Thomas Merrill¹¹⁵ – would dispute even the principle that, if the removal of the ADC constituted a relevant breach of regulatory contract that prevented Telstra earning a reasonable return on their investment, then Telstra should be compensated through, for example, a gradual phasing out of the ADC.

142 It is common ground that the theory of deregulatory takings supports compensation for an incumbent firm when an unanticipated change in regulation that constitutes a breach of the regulatory contract systematically reduces the ability of an incumbent firm to earn a reasonable return on their investments. There are three reasons why the removal of the ADC does not fulfil the criteria under which the theory of deregulatory takings suggests the need for compensation:

- (a) *the removal of the ADC is not unexpected.* As discussed above, Telstra has no reason to find the removal of the ADC from access prices unexpected. The Commission's inclusion of the ADC in access prices was never the subject of a legally authoritative decision. The whole issue of PSTN access pricing was before the ACT but no determination was made. Furthermore, Telstra has been aware since at least April 2002 that it is government policy to remove the ADC. As a result, Telstra should reasonably have considered the possibility of the removal of the ADC when making its investment decisions and need not be compensated for the effect of the removal of the ADC on its investments;
- (b) *the removal of the ADC does not impede the ability of Telstra to earn an adequate return on its investments.* As Sidak and Spulber argue in support of the theory of deregulatory takings, the fundamental concern with regulatory change is the effect of the change on investment incentives:

“. . . the overriding purpose of the regulatory contract is to induce the public utility to make specialized investments.”¹¹⁶

¹¹⁵ See, for example: O Williamson (1996) “Deregulatory Takings and Breach of the Regulatory Contract: Some Precautions”, 71(4) *New York University Law Review* 1007; W Baumol and T Merrill (1996) “Deregulatory Takings, Breach of the Regulatory Contract, and the Telecommunications Act of 1996”, 71(4) *New York University Law Review* 1037.

¹¹⁶ J Sidak and D Spulber, (1996) “Deregulatory Takings and Breach of the Regulatory Contract”, 71(4) *New York University Law Review* 851 at 945.

AAPT recognises this concern, but submits that the removal of the ADC from access prices does not diminish Telstra's incentives to make reasonable investments. In fact, TSLRIC+ access prices, without the inclusion of an ADC, are explicitly designed to provide an adequate return on reasonable investments. Consequently, the removal of the ADC from access prices does not in any way constitute a breach of the regulatory contract; and

- (c) *the removal of the ADC does not constitute a breach of a regulatory contract.* Even if it were the case that the removal of the ADC from access charges was unexpected, the removal of the ADC does not constitute a breach of a regulatory contract. Sidak and Spulber have explicitly stated that they do not consider that changes to rates of return provided to regulated firms constitute a breach of a regulatory contract:

“Changes in the mechanism of rate adjustment are an administrative procedure instead of a fundamental change in contract terms.”¹¹⁷

AAPT submits that a change to the Commission's model prices can, at most, be considered a change in administrative procedure, rather than a fundamental change in contract terms. This is particularly the case since the Commission's model terms are non-binding.

- 143 For these reasons, AAPT submits that even supporters of the theory of deregulatory takings are unlikely to suggest that Telstra requires some compensation for the effects of the Commission's decision to exclude an ADC from access prices. Consequently, in AAPT's submission, there is no justification for a gradual phase out of the ADC to protect Telstra's business interests.

Timing of LCS declaration variation

- 144 In previous decisions the Commission has demonstrated a concern for the effects of making immediate regulatory changes. For instance, in granting exemption from declaration of LCS services in the CBDs of Sydney, Melbourne, Brisbane, Adelaide and Perth, the Commission delayed exemption for one year in order to give carriers time to adjust their business decisions:

“ . . . carriers would likely need time to adjust their business plans in the wake of an exemption of the Local Carriage Service in the areas covered. This also recognised that potential alternatives to the Local Carriage Service may take time to be arranged. The delay was considered necessary to help satisfy the objectives of promoting competition and encouraging economically efficient use of an investment in infrastructure and thereby promote the LTIE.

. . . The Commission also believes that any longer period before the exemption were to take effect would defeat the basis for granting the exemption.”¹¹⁸

145 AAPT submits that, if the Commission considers a gradual phase out of the ADC is deemed necessary, the phase out period should be undertaken over a shorter period. A phase out period of 3 years is not only more than is necessary to allow carriers to adjust their business decisions, but it unnecessarily delays the promotion of the legislative objectives.

Conclusion on phasing out of the ADC

146 AAPT submits that these arguments suggest that the ADC should be removed more quickly than proposed by the Commission in its Draft Determination. AAPT considers that the legislative criteria would best be promoted by completely removing the ADC from access prices twelve months from the date of issue of the Commission's Draft Determination.

147 As argued above, AAPT submits that competition and efficiency are best promoted by the rapid removal of the ADC. However, AAPT recognises that concerns have been raised that an immediate removal of the ADC could interfere with Telstra's investment incentives or Telstra's legitimate commercial interests. While AAPT considers that this is unlikely, a twelve month adjustment period would clearly provide sufficient time for businesses to adjust their plans and, at the same time, avoid the distortions to efficiency and competitiveness that would be associated with a longer delay. AAPT also notes that a twelve month delay prior to the removal of the ADC is consistent with the Commission's decision in its variation to the LCS declaration.

¹¹⁷ J Sidak and D Spulber, (1996) “Deregulatory Takings and Breach of the Regulatory Contract”, 71(4) *New York University Law Review* 851 at 928.

¹¹⁸ ACCC, *Future Scope of the Local Carriage Service: Final Decision*, July 2002, page 60.

Annexure A: Treatment of the Access Deficit in the United States, Canada, the European Union and the United Kingdom

- 1 In its submission to the Commission's discussion paper on the ADC, Telstra seeks to imply that the use of charges equivalent to ADCs continues to find favour in foreign jurisdictions. This is clearly not the case. ADCs have been widely rejected by foreign telecommunications regulators as distortionary, inefficient, anti-competitive, administratively burdensome, lacking transparency and a deterrence to entry. In a recent benchmarking report for Telecom New Zealand, Ovum found that of the countries it considered – which included Australia, Canada, the United Kingdom, the United States, France, Germany, Japan, Finland and the Netherlands – only Australia included an ADC in its interconnect charges.¹¹⁹
- 2 Telstra's attempts to find support for an ADC in the United States, Canada, the EU and the United Kingdom are potentially misleading. None of these jurisdictions include an equivalent of an ADC in their interconnect charges, and several of the telecommunications regulators from these jurisdictions are highly critical of the use of ADCs.

United States

- 3 While Telstra recognises that the United States does not have a formal ADC, Telstra nevertheless claims that certain access charges in the United States play a similar role to the ADC. According to Telstra, the Carrier Common Line Charge (CCLC) and the Pre-subscribed Interexchange Carrier Charge (PICC), are similar to an ADC.
- 4 To characterise the CCLC and the PICC as equivalent to an ADC in the Australian context appears to ignore the fact that the CCLC and the PICC are designed to constitute part of a USO scheme. This is acknowledged by the FCC in the decision to which Telstra makes reference in its attempts to characterise the CCLC and the PICC as ADCs:

“Recognizing the disruptive effects that competition would have on universal service support mechanisms developed in a monopoly environment, Congress instructed the Commission, after consultation with the Federal-State Joint Board on Universal Service (Joint Board), to establish specific, predictable, and sufficient mechanisms to preserve and advance universal service. Congress concluded that the support provided by these mechanisms “should be explicit and sufficient to achieve the purposes” of section 254, which include the purpose that

¹¹⁹ Ovum, *New Zealand Interconnect Benchmark: A Report for Telecom New Zealand*, May 2002, page 7.

all Americans should have access to telecommunications services at affordable and reasonably comparable rates. In response to this directive, the Commission has taken several actions to put in place universal service support mechanisms that will be sustainable in an increasingly competitive marketplace. These actions fall into three general categories: (1) reforming our existing universal service support mechanisms; (2) reforming our interstate access charge regime to identify implicit universal service support and to remove such implicit support from our interstate access charges, and (3) establishing new universal service mechanisms. In this Order we focus our efforts in these last two categories.”¹²⁰

- 5 It is appropriate to acknowledge that there is a relationship between the CCLC and the PICC, on one hand, and the ADC, on the other. AAPT also recognises that there is a relationship. As discussed in the body of the submission, AAPT recognises this relationship and, in fact, submits that the USO scheme insures Telstra against incurring and access deficit.
- 6 The Federal Communications Commission’s (FCC) report is a report on the reform of a USO scheme. The FCC report can, therefore, be taken as relevant to the design and implementation for Australia’s USO scheme, but nothing in the report can be taken in support of an ADC in addition to a USO scheme.
- 7 The same is true for section 254 of the United States’ *The Telecommunications Act 1996*, which Telstra also invokes in support of its claims for an ADC. This section is concerned with the criteria for a USO scheme, and makes no reference to an ADC. The criteria outlined in section 254 cannot be presumed to support an ADC.

Canada

- 8 In paragraph 39 of its submission, Telstra quotes a Canadian Radio-television and Telecommunications Commission (CRTC) decision and seeks to imply that the quotation constitutes support on the part of the CRTC for the levying of an ADC.
- 9 The quotation Telstra relies upon is simply a statement of the CRTC’s criteria to evaluate the contribution regime that subsidises the high cost of local services in rural and remote areas. Whether an ADC would meet these criteria is an open question, which neither Telstra nor the CRTC address.¹²¹

¹²⁰ Federal Communications Commission, “Sixth Report and Order in CC Docket Nos. 96-262 and 94-1 Report and Order in CC Docket No. 99-249 Eleventh Report and Order in CC Docket No. 96-45”, May 2000, para 25.

¹²¹ While Telstra implies that the criterion of avoiding unfair advantages suggests the need to levy an ADC, this is in fact not the case. As argued in paragraph in this submission, an ADC will in fact provide an unfair advantage to Telstra.

10 The CRTC does not address the question of whether an ADC would meet the criteria because the decision from which this quote is taken, and for which Telstra does not provide a complete reference, never addresses the question of whether an ADC should be levied. The document is the CRTC's decision on changes to Canada's contribution regime and, as such, is explicitly concerned for contributions to universal service. As stated in the first sentence of this decision, the CRTC is concerned with a contribution regime to subsidise the cost of providing services in *high cost rural areas*:

*"The Commission is introducing major changes to the Canadian telecommunications contribution regime, which subsidises the high cost of local service in rural and remote areas."*¹²²

11 The CRTC's decision relates to the equivalent of Australia's USO scheme, and does not relate to an ADC. The CRTC does not advocate any ADC scheme in addition to its equivalent of the USO scheme. This is particularly evident given that the CRTC decided that only those services in clearly defined high-cost areas are eligible for a contribution.¹²³

12 As a further point, it is important to note that, in this decision, the CRTC determined that the total required contribution towards the cost of providing basic access should be decreased to reflect the implicit contribution that local call services make to the cost of providing basic access:

"The total subsidy requirement (TSR) to be set for each ILEC consists of four basic components:

- a) primary exchange residential service revenues;*
- b) primary exchange residential service costs established on the basis of Phase II costing methodologies;*
- c) a mark-up on the Phase II costs of primary exchange residential services to provide an appropriate contribution to fixed and common costs; and*
- d) an implicit contribution generated by other local services utilized by residential subscribers."*¹²⁴

13 The CRTC determined that treating basic access as a joint product used in conjunction with other local services, and that deducting from the costs of providing basic access the

¹²² CRTC, *Changes to the contribution regime*, November 2000, Decision CRTC 2000-745. In its submission on the ADC, Telstra quotes from paragraph 9 of this decision.

¹²³ World Bank, *Telecommunications Regulation Handbook*, 2000, p 6-46.

¹²⁴ CRTC, *Changes to the contribution regime*, November 2000, Decision CRTC 2000-745, para 50.

implicit contribution made by these profitable services, was in accord with the decision criteria quoted by Telstra.

- 14 In short, it is incomplete to claim that the CRTC's regime "seeks to ensure that LECs are compensated for the total revenue shortfall." LECs are only compensated for the total revenue shortfall in certain high cost areas, and are compensated for a total revenue shortfall that is reduced to reflect the contribution of other telephony services to the costs of providing basic access.

The European Union

- 15 Telstra discusses the approach of the European Commission (EC) to ADCs in Attachment 2 of its discussion paper. While Telstra acknowledges that the EC has taken steps to restrict the application of ADCs, Telstra's discussion is nevertheless somewhat misleading: Telstra suggests that the EC took these steps to rule out ADCs on the basis that re-balancing of tariffs made an ADC unnecessary. In fact, the EC advocated a process of re-balancing due, in large part, to problems with the use of ADCs.
- 16 In issuing its guidelines for the operation of USO schemes, the EC noted in an annexure the following problems with ADCs:

"In principle, access deficit schemes take the retail price structure (or the profitability of the various business areas) of the incumbent as the starting point for calculating the interconnection price, and allow a discount on these prices to give the price for interconnect for a particular type of call or service. The calculation is therefore top down, rather than a bottom up approach based on the actual costs incurred.

As a result any access deficit scheme will prevent effective competition from becoming established as competitors (entrants) will be forced to charge higher prices for those services, which contribute to the incumbent's access deficit. This type of interconnection pricing regime undermines the incentives for the incumbent to orient its prices towards cost. These effects distort investments within the industry and can only be considered as a temporary exception to the Treaty competition rules."¹²⁵

- 17 The EC reiterated these distortionary effects of ADCs, as well as noting the problems associated with administering ADCs, in its recommendations on interconnection:

¹²⁵ Commission of the European Communities, *Assessment Criteria for National Schemes for the Costing and Financing of Universal Service in telecommunications and Guidelines for the Member States on Operation of such Schemes*, November 1996, Annex B.

“Access deficit contribution schemes always provide inefficient investment signals, and raise overall industry costs. They are also administratively cumbersome, and lack transparency.”¹²⁶

- 18 In short, the EC took steps to eliminate the application of ADCs in the European Union because such schemes are inefficient, anti-competition, administratively burdensome and non-transparent, not because such schemes were no longer necessary.

United Kingdom

- 19 Telstra claims in its discussion paper that the UK Office of Telecommunications’ (**Oftel**) decision not to allow British Telecom plc (**BT**) to recover an ADC merely reflects a recognition on the part of Oftel that no relevant access deficit existed for BT.

- 20 However, Oftel, in its review of interconnection, found significant problems with ADCs:

“The problems with ADCs were rehearsed in the December Document – their basis in fully-allocated costs, their complexity of administration and the uncertainty they create in the market place. They have become a major source of uncertainty for those considering investing in the UK telecommunications market. . . . To continue with ADCs would institutionalise a significant distortion of the market.”¹²⁷

- 21 In light of these problems, Oftel removed the constraint imposed by the price cap in order to remove any argument for the recovery of an ADC. In other words, Oftel did not decide to exclude an ADC on the basis that there was no access deficit, but removed the constraint on line rental charges, and thus the access deficit, specifically in order to overcome problems with the levying of an ADC.

- 22 Oftel recognised that there were significant advantages to the removal of the ADC:

“In considering changes to the present regime Oftel is concerned to ensure that interconnection charges better reflect how a business operating in a normal, competitive market would set its charges. Interconnection charges which provide the appropriate economic signals will promote efficient and sustainable competition in infrastructure and services and encourage effective, competitive pressures to reduce costs. Oftel also aims to reduce the complexities of current regulation. Without change these complexities will increase and so will uncertainties for firms considering investing in new infrastructure and services in the UK. Greater clarity in regulation is good for operators and for consumers too. Oftel made clear in the Consultative Document its strong preference for abolishing ADCs, for moving towards incremental costs as the basis for interconnection charging and for moving as far towards Option 4 [switching from

¹²⁶ Commission of the European Communities, *Commission Recommendation on Interconnection in a liberalised telecommunications market*, October 1997, Annex 1.

¹²⁷ Oftel, *Effective Competition: Framework for Action*, July 1995, paras 3.18-3.19.

systematic regulation to policing of the market through competition rules] as the extent of effective competition in the market would allow.”¹²⁸

23 Interestingly, even following the removal of the retail price cap, BT did not increase its line rental charges by the amount required to recover the access deficit that BT had claimed it incurred, which suggests that the access deficit was no deficit at all. As Walden and Angel write:

“ . . . in 1996, BT’s licence was modified and the RPI – 2% line rental constraint was lifted, resulting in the access deficit being removed. It was envisaged that given BT had claimed for so long the efficiency of rebalancing, it would raise line rentals accordingly so as to collect the extra £1.5 billion to finance the ‘access deficit’. In practice, it did not increase them by the 80 per cent required to collect this extra amount. This, therefore, confirmed the viewpoint that it would not be in BT’s interests to make a large rebalancing price change; instead it would be better to price to maximise its long-term value and profit.”¹²⁹

24 It is also inaccurate to say that Oftel did not think that BT’s competitors should be excused from bearing the costs of any access deficit. Before Oftel decided to prevent the recovery of the access deficit through inflated access charges, Oftel exhibited reluctance to enforce the payment of an ADC by access seekers. During the period in which ADCs were accepted in principle, the Director-General of Telecommunications enjoyed discretion to waive the ADC subject to a set of rules regarding the market share of entrants. In 1994 and 1995, Oftel granted 35 separate ADC waivers to access seekers.¹³⁰ As recognised in a paper by Valletti – and cited by Telstra in its submission – the effect of these waivers was that, even during the period that Oftel supported the principle of the recovery of the access deficit through an ADC, the charge was paid for only a very few years and only for international calls.¹³¹

¹²⁸ Oftel, *Effective Competition: Framework for Action*, July 1995, para 2.2.

¹²⁹ Walden and Angel, *Telecommunications Law*, 2001, Blackstone Press: London, page 36.

¹³⁰ Oftel, *A brief history of recent UK telecoms and Oftel*. Available at: <http://www.oftel.gov.uk/about/history.htm>

¹³¹ Valletti, Tomasso, “The practice of access pricing: Telecommunications in the United Kingdom”, 1999, London School of Economics, Politecnico di Torino and CEPR paper prepared for the Economic Development Institute, The World Bank, page 9.

Annexure B: J Gans and S King, *Evaluating Telstra's Undertaking for CAN Cost Recovery*

Annexure C: J Gans and S King, *Competitive Neutrality in Interconnection Pricing*

***Annexure D (Confidential): J Gans, Reducing PSTN
Interconnection Charges Will Lower Retail
Telecommunications Prices: A Response to Telstra's
Submission***