



**Telstra's Undertakings for the
PSTN Originating and Terminating and LCS Access
Services**

Discussion Paper

May 2006

1 Introduction

Part XIC of the *Trade Practices Act 1974* (the Act) establishes a regime for governing access to certain services in the telecommunications industry. Under Part XIC, providers of an active declared service (“access providers”) have an obligation to supply that service.

Telstra lodged access undertakings (the Undertakings) specifying price-related terms and conditions upon which it undertakes to meet its standard access obligations to supply the PSTN originating and terminating access services (PSTN O/TAS) and the Local Carriage Service (LCS). The Undertakings were lodged on 22 March 2006, but the public versions of Telstra’s supporting submission were not received until 29 March 2006.¹

The declared PSTN O/TAS are supplied by Telstra to other service providers, who use them as inputs to provide retail services to end-users, such as long distance calls, in competition with Telstra. In addition to long distance services, such as STD and IDD, the PSTN O/TAS are used as inputs to provide fixed-to-mobile (‘FTM’) and mobile-to-fixed (‘MTF’) calls to end-users in Australia. They are also used by other network operators to interconnect with Telstra’s fixed network, including HFC, mobile and ULLS-based providers². The PSTN O/TAS were declared at the outset of the Part XIC regime on 1 July 1997.

The LCS is a service used by access seekers for local call resale. It is a service for the carriage of telephone calls from customer equipment at an end-user’s premises to the separately located customer equipment of another end-user in the same standard zone.³ After holding a public inquiry, the Commission declared the LCS in August 1999.

Telstra lodged a set of access undertakings with the ACCC on 9 January 2003 specifying the price-related terms and conditions upon which it undertook to meet its standard access obligations (SAOs) to supply the PSTN O/TAS, the Unconditioned Local Loop Service (ULLS) and the LCS (the core services).

In October 2003, the ACCC published its model price and non-price terms and conditions for core services, including for the PSTN O/TAS and LCS. Subsequently, Telstra withdrew its 9 January 2003 undertakings and submitted replacement undertakings on 14 November 2003, which would cover the period to June 2006. The PSTN and LCS undertakings were accepted by the ACCC in December 2004.

The regulatory regime only provides for the ACCC to accept or reject an undertaking and there is no provision to approve part of an undertaking or approve an undertaking on a conditional basis. This means that any changes or amendments to an undertaking require a fresh undertaking to be re-submitted and a further assessment process.

Telstra’s proposed undertakings involve a substantial restructuring of the pricing structure for fixed network services which will require detailed consideration. While the ACCC will seek

¹ Confidential versions of the submissions had been provided on 22 March 2006.

² ULLS-based providers supply voice, data, internet and other services to customers using Telstra’s unconditioned local loop service or the basic copper connection between the local exchange and the customer. When such customers need to make calls back into Telstra’s fixed network, the ULLS-based provider needs to purchase PSTN terminating access services from Telstra.

³ Standard zone has the same meaning as in Part 4 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999*.

to expedite its consideration of these undertakings as far as possible, its consideration of these matters is unlikely to be concluded by 30 June.

It is always open to companies to commercially negotiate price and non-price terms and conditions for the PSTN O/TAS and LCS. However, the ACCC would be concerned if Telstra pre-emptively or unilaterally changed the pricing structures of these services to competitors prior to the ACCC having had the opportunity to fully assess the proposed undertakings within the time-frames under the Act.

The ACCC is obliged to assess undertakings in accordance with current statutory provisions and this process, outlined in this paper, is consistent with this. Under the current legislative provisions, the ACCC must consider each of the undertakings that Telstra has lodged and decide to accept or reject them. The purpose of this Discussion Paper is to:

- inform parties of the matters the ACCC must take into consideration in making the decision to accept or reject an undertaking
- specify a number of issues the ACCC would particularly like addressed in submissions
- outline the process the ACCC will follow in assessing the undertakings.

In accordance with sections 152BU and BV, the ACCC seeks submissions on the Undertakings and the issues identified in this Discussion Paper. If a party wishes to make a submission, the submissions must be provided to the ACCC no later than 6 weeks from the date of publication of this Discussion Paper. This paper was released on **5 May 2006**, meaning that submissions are due by **16 June 2006**.

Parties wishing to obtain confidential information referred to in this Discussion Paper, for the purposes of preparing a submission, should contact Nadia Ceh of Telstra on 02 9298 5594. The confidential information includes information that is referred to in Telstra's submissions as 'confidential' and the electronic versions of cost models used by Telstra to support its proposed charges.

The ACCC considers that, in the absence of formal procedural rules, which are currently being developed (see below), the process previously used by Telstra and interested parties for obtaining access to Telstra's confidential information in the course of Telstra's previous core service undertakings is a reasonable process and can be used for this assessment.

Accordingly, interested parties who seek access to confidential information should be aware that they may be required to sign confidentiality agreements. The terms of any confidentiality agreements are largely a matter between Telstra and the interested party.

In setting the 6 week period for the lodging of submissions to the Discussion Paper, the ACCC has allowed a period of 2 weeks for parties to arrange access to confidential information and a period of 4 weeks for submissions to be drafted.

The ACCC considers that the extensive previous consultation process on the ULLS and LSS and the fact that interested parties have previously entered into confidentiality arrangements with Telstra means that a simpler, more streamlined process involving a specific 6 week timeframe can be used.

The ACCC will soon be developing procedural rules under the new s. 152ELA of the Act and anticipates that such rules will apply to the processes for undertaking assessments in the future, including rules relating to the confidentiality of documents given to the ACCC in this regard.

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2 The role of undertakings and Legislative criteria for the assessment of undertakings

Under Part XIC of the Act, the ACCC may declare carriage services and related services to be declared services. Carriers and carriage service providers who provide declared services are required to comply with standard access obligations (“SAOs”) in relation to those services. The SAOs facilitate the supply of declared services by access providers to access seekers, in order that access seekers can provide carriage services and/or content services.

Section 152AY(2) of the Act (detailed below) specifies the way the terms and conditions upon which the access provider must comply with the SAOs are determined:

The carrier or carriage service provider must comply with the obligations:

(a) on such terms and conditions as are agreed between the following parties:

- (i) the carrier or carriage service provider, as the case requires;
- (ii) the access seeker; or

(b) failing agreement:

(i) if an access undertaking given by the carrier or carriage service provider is in operation and specifies terms and conditions about a particular matter – on such terms and conditions relating to that matter as are set out in the undertaking; or

(ii) if an access undertaking given by the carrier or carriage service provider is in operation, but the undertaking does not specify terms and conditions about a particular matter – on such terms and conditions relating to that matter as are determined by the Commission under Division 8 (which deals with arbitration of disputes about access); or

(iii) if there is no such undertaking – on such terms and conditions as are determined by the Commission under Division 8 (which deals with arbitration of disputes about access).

2.1 Legislative criteria

Section 152BV of the Act sets out the obligations of the ACCC in assessing an undertaking.

(1) This section applies if:

(a) an ordinary access undertaking is given to the Commission by a carrier or a carriage service provider; and

(b) the undertaking does not adopt a set of model terms and conditions set out in an approved telecommunications access code.

(2) The Commission must not accept the undertaking unless:

(a) the Commission has:

(i) published the undertaking and invited people to make submissions to the Commission on the undertaking; and

(ii) considered any submissions that were received within the time limit specified by the Commission when it published the undertaking; and

(b) the Commission is satisfied that the undertaking is consistent with the standard access obligations that are applicable to the carrier or provider; and

(c) if the undertaking deals with a price or a method of ascertaining a price – the Commission is satisfied that the undertaking is consistent with any Ministerial pricing determination; and

(d) the Commission is satisfied that the terms and conditions specified in the undertaking are reasonable; and

(e) the expiry time of the undertaking occurs within 3 years after the date on which the undertaking comes into operation.

Published the undertaking and invited people to make submissions

The ACCC has previously published Telstra's Undertakings by placing these on its website (see <http://www.accc.gov.au>). With the release of this Discussion Paper, the ACCC is now inviting parties to make submissions on the Undertakings.

The Discussion Paper has been informed by the information provided by Telstra in its submission supporting the Undertakings. That submission includes information over which Telstra has made a confidentiality claim.

Telstra has provided public versions of its submission in support of the Undertakings. These have been posted on the ACCC's website for the purpose of assisting interested parties to make submissions in response to this Discussion Paper.

While the ACCC will, as required, have regard to all submissions that are made to it on or before the closing date for submissions, the ACCC strongly encourages all interested parties to make their submissions as soon as they are in a position to do so. In particular, the ACCC requests that should a party intend to make a submission on any matter not addressed in this Discussion Paper, it notify the ACCC of its intentions as soon as possible.

The ACCC also encourages parties to make their submissions in a way that facilitates the efficient assessment of its various contentions, including the verification of any facts or data upon which those contentions are based. In this regard, parties are encouraged to restrict confidentiality claims to a minimum and to establish appropriate confidentiality regimes for the disclosure of any information that is claimed to be confidential to interested parties or to others to allow for their critical assessment. Accordingly, the ACCC requests that should it be the case that a party intends to provide confidential material in support of a submission, that it also provide a non-confidential version which can be used for public disclosure, together with a confidentiality claim, at the same time.

Considered any submissions that were received within the time limit specified by the ACCC when it published the undertaking

The time limit specified by the ACCC for the receipt of submissions on the Undertakings is 6 weeks from the date publication of this discussion paper. The 6 week period specified by the ACCC allows for 2 weeks for issues of access to Telstra's confidential information to be resolved and 4 weeks for the preparation of submissions. The confidential information includes:

- (a) information contained in Telstra's submissions in support of the Undertaking
- (b) Telstra's cost models used to derive the proposed monthly access charges and connection charges.

The ACCC has set the period over which it will consult on the Undertakings (the 'Consultation Period') to ensure that interested parties will be in a position to properly assess the Undertakings and make submissions on them. Interested parties wishing to obtain access

to the confidential material should contact Telstra. Parties are encouraged to provide their submissions to the ACCC at the earliest possible opportunity.

Following its analysis of the Undertakings, and the submissions of interested parties, the ACCC expects to publish the findings of its initial analysis and its draft decisions. This will occur within a reasonable period after submissions close. The ACCC will invite further submissions on its draft decisions for a specified period.

Taking into account submissions made by interested parties, the ACCC will form a final view on whether to accept or reject the Undertakings and publish the reasons for its decisions. A more detailed description of the assessment process is outlined in Chapter 3, below.

Consistency with standard access obligations

The SAOs are set out in s.152AR of the Act. Subject to class or individual exemptions made by the ACCC, a carrier or carriage service provider must comply with the SAOs in regard to declared services it supplies either to itself or to other persons.⁴ In particular, s.152AR requires access providers to, among other things:

- supply an active declared service if requested to do so by a service provider (subject to certain limitations) and to take all reasonable steps to ensure that the technical and operational quality of the active declared service supplied to the service provider is equivalent to that which the access provider provides to itself
- permit the interconnection of the facilities an access provider either owns, controls or is responsible for, with the facilities of a service provider for the purpose of enabling the service provider to be supplied with active declared services
- take all reasonable steps to ensure that the technical and operational quality and timing of the interconnection is equivalent to that which the access provider provides to itself and is compliant with any technical standards in force under section 384 of the Telecommunications Act 1997
- provide billing information (if requested by the service provider) at certain intervals and in a certain manner and form.

The ACCC will assess whether the undertakings, including the service descriptions, are consistent with the SAOs.

Consistency with Ministerial pricing determination

Division 6 of Part XIC provides that the Minister can make a written determination setting out principles dealing with price or a method of ascertaining price relating to the SAOs. Section 152CI(1) of the Act provides that if a provision of an access undertaking is inconsistent with any Ministerial pricing determination, the provision will have no effect to the extent of the inconsistency.

The Minister has not made a pricing determination under Part XIC to date.

⁴ Sections s.152AS and s.152AT of the Act. The ACCC has not made any such exemptions to date.

Terms and conditions are reasonable

An important part of the access regime is the terms and conditions of access (including the price or a method for ascertaining the price). Under Part XIC of the Act, the ACCC cannot accept an undertaking unless it is satisfied that the terms and conditions specified are reasonable. In determining whether terms and conditions are reasonable, regard must be had to the following matters:

- whether the terms and conditions promote the long term interests of end-users (the LTIE)
- the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or carriage service provider's investment in facilities used to supply the declared service concerned
- the interests of persons who have rights to use the declared service concerned
- the direct costs of providing access to the declared service concerned
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility
- the economically efficient operation of a carriage service, a telecommunications network or a facility.⁵

This does not, by implication, limit the matters to which regard may be had.⁶

In considering whether the terms of an access undertaking promote the LTIE, the ACCC must consider the achievement of the following objectives:

- promoting competition in markets for telecommunications services
- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users
- encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied.⁷

Expiry Date and Term

The Undertakings cover the period from acceptance to the end of the 2007/08 financial year. The Undertakings have no effect in respect of the period that precedes any acceptance by the ACCC, and may be withdrawn by Telstra before their expiry dates. The declarations for the services covered by the Undertakings expire during the undertaking periods, unless they are extended by the ACCC. In this regard, the ACCC is currently considering the future declaration of the declared services covered by the Undertakings as part of its fixed services review.⁸ In the event the ACCC does not re-declare these services, the Undertakings will cease having effect beyond the declaration expiry dates, even if approved by the ACCC before then.

⁵ Sub-section 152AH(1) of the Act.

⁶ Sub-section 152AH(2) of the Act.

⁷ Sub-section 152AB(2) of the Act.

⁸ ACCC *A strategic review of the regulation of fixed network services—an ACCC discussion paper*, December 2005.

3 ACCC's Process for Assessing the Undertaking

The process the ACCC will follow to assess the Undertakings will be as open and public as practicable, allowing parties to express their views on the Undertakings, provide relevant information to assist the ACCC and allow comment on preliminary views formed by the ACCC and its analysis of the Undertakings.

The ACCC intends to adopt the following process in assessing the Undertakings.

Stage 1: Publish the undertaking and seek submissions

As stated above, the ACCC has published the Undertakings and is making them available to all parties.

The closing date for submissions in stage 1 is 6 weeks from the date of publication of this discussion paper. The ACCC has set the consultation period on this basis to better ensure that interested parties will be in a position to assess the Undertakings and make submissions on them.

Stage 2: Publish draft assessment and seek further submissions

Following its analysis of the Undertakings and the submissions of interested parties, the ACCC intends to publish the findings of its initial analysis and its draft decision within a reasonable period after submissions close. The ACCC will invite further submissions on its draft decision for a specified period, which will likely be considerably shorter than this initial period.

The ACCC would expect that these submissions would be responsive to the draft decision, and would not expect a party to raise any further issues that were not addressed in the submissions that the party made during Stage 1 as discussed above. Parties are advised that, due to the statutory imposed timetable within which the ACCC must make its decision, the period within which these responsive submissions will be able to be made will be comparatively brief.

Stage 3: Publish final assessment

Taking into account the submissions, the ACCC will form a view on whether to accept or reject the Undertakings and publish the reasons for its decision.

The ACCC will have a clearer idea of this timeframe as its assessment progresses through the identified stages.

3.1 Time limit for final assessment

The Telecommunications Competition Act 2002 has introduced a time limit for the ACCC's assessment of undertakings. While the ACCC would intend to make its decision as soon as is practicable for it to do so, the ACCC must in any event make a decision within 6 months. If it does not do so, it is deemed to have accepted the Undertakings. However, the ACCC is able to extend its decision-making period for up to 3 months at a time provided it gives a reason for doing so. In addition if the ACCC requests further information in relation to the Undertakings, the time taken for the ACCC to receive the information is excluded from the 6

month period. Similarly, the consultation period specified by the ACCC is excluded from this timeframe.⁹

3.2 Confidentiality

The ACCC is aware of the need to protect confidential information provided by interested parties. Therefore, the ACCC is not opposed to parties who wish to have access to such confidential information signing confidentiality undertakings. However, the ACCC believes that these confidentiality undertakings should enable the relevant party to view all information supplied by Telstra and other parties to the ACCC in these proceedings. Should Telstra or other parties choose not supply any confidential information to parties who wish to have access to it, the ACCC's policy is that such information will generally not carry the same weight as information that is available for scrutiny by all sides of an issue or debate.

In addition, the ACCC notes that it is unlikely to accept any confidentiality claims over economic thought or arguments. In fact, the ACCC believes that public debate over economic arguments is essential to the assessment process.

⁹ Revised section 152BU (5), (6) & (7) of the Act.

4 Undertakings – issues for discussion

Proposed charges

Telstra's proposed 'headline' charges are as follows:

	2006/07	2007/08
LCS (per call)	\$0.0928	\$0.0928
PSTN TA and PSTN non-preselect OA (per minute)	\$0.0218	\$0.0228
PSTN Preselect OA - per minute charge	\$0.0119	\$0.0124
- per customer per month	\$1.44	\$1.48

However, Telstra geographically de-averages the majority of these charges away from these 'headline' charges, with the exception of the LCS charge and the 'per customer' PSTN POA charges, as follows:

PSTN TA and PSTN non-preselect OA

	2006/07		2007/08	
	flagfall	per minute	flagfall	per minute
CBD	\$0.0107	\$0.0136	\$0.0108	\$0.0141
Metro	\$0.0112	\$0.0139	\$0.0115	\$0.0145
Provincial	\$0.0134	\$0.0144	\$0.0137	\$0.0151
Rural	\$0.0378	\$0.0387	\$0.0386	\$0.0402

PSTN preselect OA

	2006/07		2007/08	
	\$1.44 per customer plus		\$1.48 per customer plus	
	flagfall	per minute	flagfall	per minute
CBD	\$0.0035	\$0.0051	\$0.0034	\$0.0052
Metro	\$0.0042	\$0.0055	\$0.0043	\$0.0058
Provincial	\$0.0068	\$0.0065	\$0.0069	\$0.0068
Rural	\$0.0343	\$0.0340	\$0.0349	\$0.0352

Telstra's proposed Undertaking prices involve a substantial reduction in the headline LCS prices and an increase in the headline PSTN OTA prices. The proposed LCS price for both 2006/07 and 2007/08 is a 32% reduction compared with the 2005/06 price. The proposed PSTN OTA prices have increased by 118% in 2006/07 and by 128% in 2007/08 compared to 2005/06. With respect to the per minute PSTN OTA prices, Telstra's Undertaking are deaveraged by four geographic zones. According to Telstra, this is to ensure full recovery of efficient costs and as a result of declining traffic volumes on the PSTN.

Basis for proposed charges

Interpretation and application of section 152AH

Telstra has submitted that in determining whether Undertaking prices are reasonable, the relevant inquiry is not whether the Undertaking prices are the 'most appropriate', but whether they are reasonable. Implicit in this submission is the assertion that the Commission may have rejected Undertakings previously because the model chosen has not been the model considered by the Commission to be the 'most appropriate'. Telstra submits that, in applying the test of 'reasonableness', the Commission must consider whether the proposed model is within a "range of choice reasonably open and consistent with the criteria in section 152AH(1)".

Telstra has also submitted that, for the purpose of assessing the reasonableness of the Undertaking, three broad principles should be applied:

- full cost recovery and no more;
- encouraging efficient use of the network; and
- maintaining competitive neutrality.

Telstra submits that, if pricing meets these three broad principles, the pricing will be consistent with the statutory criteria set out in section 152AH.

Under s 152BV(2)(d), the ACCC must not accept an Undertaking unless it is satisfied that the terms and conditions specified in the Undertaking are reasonable. Section 152AH sets out the matters to which the ACCC must have regard in determining whether particular terms and conditions are reasonable. Section 152AB(2) provides that, in relation to determining whether something promotes the LTIE (as specified in s 152AH(1)(a)), regard must be had to whether certain enumerated objectives will be achieved.

Against that background, the ACCC believes:

- the terms and conditions of the Undertaking as a whole that must be taken into account;
- any methodology used to assess the terms and conditions must be conducted subject to the requirements of s 152AH(1) and 152AB(2); and
- having regard to the statutory criteria, the terms and conditions must be consistent with or reflect the likely outcome of a workably competitive market.

The ACCC believes that the choice of methodology for assessment of the terms and conditions and the ultimate reasonableness of those terms and conditions are not to be determined simply according to the ACCC's preference. Alternative methodologies from 'a range of choice reasonably open' *may* be acceptable where they facilitate an assessment in accordance with the statutory criteria. Similarly, an alternative outcome (eg price) may be reasonable if it is consistent with the statutory objectives.

Questions for Submitters

Should assessments of reasonableness be conducted on the basis of the 'range of choice reasonably open and consistent with the criteria in section 152(AH)?

Do the three broad principles accurately reflect the statutory criteria and assist the ACCC in meeting its statutory obligations of assessment?

Assessment of Proposed Charges

In assessing the proposed charges contained in the Undertaking, the ACCC considers that there are two key issues which need to be examined. These are:

- assessment of the underlying costs from which the charges are derived; and
- assessment of the structure of the PSTN OTA and LCS charges proposed by Telstra.

Each of these is discussed below.

The Underlying Cost basis of the Charges

The use of the PIE II model

The PIE II model provides an estimate of the total cost pool of the IEN. The cost of the IEN is the relevant cost pool in determining PSTN OTA prices. Unlike previous undertakings relating to PSTN OTA charges, Telstra proposes not to include an explicit contribution to the cost of the Customer Access Network (CAN) in the proposed charges as recent increases in wholesale basic access charges now permit Telstra to align these charges with efficient costs of the CAN. Previously, this took the form of an access deficit contribution (ADC) which the ACCC concluded, in its last PSTN undertaking assessment in 2004, was no longer appropriate after 2006.

Whilst the ADC charge is not explicitly imposed, Telstra has limited the contribution to the cost pool by local calls by capping this on the basis of its RMAC estimate of 9.8 cents. This has had the effect of increasing the contribution from long distance, F2M calls etc. For example, while local calls represent nearly [c-in-c] of total call volumes, they only account for less than [c-in-c] of total IEN costs under Telstra's approach. Telstra claims that this results because local calls cannot recover their full costs which amounts to the addition of a local call deficit charge on PSTN rates.

Telstra claims that it has set its undertaking prices to recover the lower bound¹⁰ of its estimates of forward-looking, efficient hypothetical total IEN costs, namely [c-in-c] in 2006/07 and [c-in-c] in 2007/08.¹¹

The total IEN costs are based on Telstra's PIE II cost model, which has been used to cost PSTN access services for previous undertakings lodged with the ACCC, updated for changes in traffic volumes for various PSTN services, new WACC parameters and changes in the replacement cost of asset categories. Although it is not clear from Telstra's submission that the changes in traffic volumes has been reflected in commensurate changes to Telstra's IEN asset base.

Unlike for previous undertakings relating to PSTN O/TAS charges, Telstra proposes not to include an explicit contribution to the cost of the Customer Access Network (CAN) in the proposed charges as recent increases in wholesale basic access charges now permit to align these charges with efficient costs of the CAN.¹² Previously, this took the form of an access deficit contribution (ADC) which the ACCC concluded, in its last PSTN undertaking assessment in 2004, was no longer appropriate after 2006.

With respect to the replacement cost of the majority of the IEN asset categories, Telstra has deflated the replacement cost using broadly-based price indices derived from national accounts data for the communications sector.¹³

The difference between Telstra's lower bound and upper bound estimate of forward-looking, efficient hypothetical total IEN costs is entirely due to the adoption of a higher WACC estimate.¹⁴

Telstra has resubmitted a report from an expert economist, Dr Bridger Mitchell, that reviews Telstra's updated version of the PIE II model. This review forms Annexure B of Telstra's supporting submission. Among other things, Telstra claims Dr Mitchell endorses its view that the updated PIE II model provides for an optimised PSTN network, consistent with international best practice, and forward looking traffic or volume forecasts. Dr Mitchell has previously provided an expert opinion on the PIE II in relation to the costing of the ULLS.

Telstra claims its efficient (lower bound) future cost estimate is below its current historic and current cost estimates (for 2004/05).¹⁵ Telstra's submission describes the adjustments it has made to its regulatory accounts data submitted to the ACCC to derive historic and current account estimates of the total IEN cost.¹⁶

¹⁰ Telstra's lower bound estimate applies a point estimate of the WACC while the upper bound estimate uses the WACC uplifted by one standard deviation.

¹¹ see paragraph 40.

¹² see paragraph 40.

¹³ see paragraphs 60-62 and 65.

¹⁴ see paragraph 66.

¹⁵ see paragraph 40.

¹⁶ see paragraphs 75-77.

Telstra has also forecasted total IEN costs for the undertaking periods, based on the TSLRIC methodology and n/e/r/a cost model used by the ACCC for its assessment of PSTN charges in 1999/00 and 2000/01.¹⁷ It derives estimates for 2006/07 and 2007/08, based on a methodology described in its submission. This methodology involves distinguishing between volume and non-volume related costs, as between the years 199/00 and 2000/01, and then making adjustments to the ACCC's cost pool of 2000/01 for changes in volume and non-volume costs in the years 2006/07 and 2007/08.

In the past, the ACCC has expressed reservations about the use of the PIE II model, and particular aspects of it, to future cost the PSTN network. A general criticism made by the ACCC of the PIE II model was its lack of transparency to fully test the operation and efficacy of the model by varying input assumptions.¹⁸ The ACCC also identified specific issues with a number of aspects of the PIE II model, including, inter alia, the insufficient allocation of common network element costs to other than PSTN services.¹⁹

The ACCC notes that Telstra has not indicated that restrictions will be placed on the use that may be made of the PIE II model by interested parties. On the contrary, Telstra appears to indicate that the confidentiality undertakings it will require of interested parties for the obtaining of confidential information will not limit the extent to which parties can analyse and comment on its undertaking and supporting submissions.²⁰

In its most recent commentary on the PIE II model for the purposes of assessing Telstra's 2003 undertaking, the ACCC noted that it did not consider it necessary then to engage in a full audit of the PIE II model or incur the expense of building an alternative cost model.²¹ However, in the light of the criticisms of the PIE II model by the industry and the Commission and the passage of time that has elapsed since the ACCC commissioned its own n/e/r/a cost model for the PSTN, the ACCC has asked UK modelling group Analysys to review the PIE II model²² and is shortly going to tender on the development of an alternative model.

Questions for Submitters

Are there faults with the PIE II cost model and how should these faults be addressed?

Has Telstra improved its PIE cost model? Is it necessary to construct an alternative cost model to Telstra's updated PIE II model?

¹⁷ see paragraphs 78-83.

¹⁸ see *Assessment of Telstra's undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004, p. 57.

¹⁹ *ibid*, p. 57-58.

²⁰ see paragraph 19.

²¹ see *Assessment of Telstra's undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004, p. 58.

²² this is primarily associated with the assessment of Telstra's ULLS undertaking, but aspects common to PSTN services will also inform this assessment, as appropriate.

The proposed WACC

Telstra commissioned Professor Jerry Bowman to estimate a WACC for PSTN network costs. Professor Bowman and Telstra argue that WACC components are estimated with error, and therefore WACC is estimated with error. Further, Telstra argues that the consequences of estimation error in the WACC are asymmetric and that long-term social costs of under estimating the cost of capital are higher than the long-term social costs of over estimation.

In choosing a WACC that balances these claimed asymmetric costs, Professor Bowman proposes that a WACC should be calculated by increasing the WACC parameter point estimates by one standard deviation.

The Commission has expressed some views in relation to this approach in the past²³. In addressing the argument, the ACCC constructed a Monte Carlo simulation analysis of possible WACC estimates, based on possible ranges of parameters. These ranges were constructed based on various views on appropriate values of input parameters. However, the ACCC stated that:

While the ACCC is not yet prepared to comment on the validity of this approach to *setting* the WACC, it may be useful in assessing the reasonableness of Telstra's proposed and ACCC's WACC estimates.²⁴

The ACCC did not use the Monte Carlo analysis in its 2005 assessment reports to set the regulatory WACC, or to compensate for any so-called asymmetry of social consequences.

The ACCC notes that the appropriate WACC has been a point of contention between Telstra, access seekers, and the ACCC for some time now. So far as Telstra's submission raises any new issues, the ACCC is interested in industry views on the following:

Questions for Submitters

Having regard to the regulatory criteria in s152AH of the Act, are the costs of under estimating the WACC greater than those of over estimating the WACC (i.e. are there any asymmetric costs)?

Having regard to the regulatory criteria in s152AH of the Act, and to Telstra's supporting submissions, are there any reasons why the ACCC should alter its views on appropriate WACC?

Should different WACCs be set for network costs in different years or one WACC for the whole period of the undertakings?

If there are asymmetric costs to WACC estimation, is Telstra's proposed method of accounting for those asymmetries appropriate?

²³ Telstra's Undertakings for the Unconditioned Local Loop Service – Discussion Paper, January 2006

²⁴ ACCC, *Assessment of Telstra's ULLS and LSS Monthly Charge Undertakings – Draft Decision*, August 2005.

How should the WACC parameter point estimate be calculated?

How should the WACC parameter standard deviation be calculated?

Are there any other issues concerning the appropriate WACC, which the ACCC should consider?

Volume forecasting

In estimating the efficient IEN cost of its PSTN using its PIE II cost model, Telstra includes confidential (c-i-c) estimates of the traffic volumes, in term of minutes, for the services that require use of the PSTN.²⁵

Telstra's submission notes public statements by it of expected declining use of PSTN services, particularly of local and long distance services.²⁶ With respect to local calls, the ACCC notes Telstra's contention that the lower LCS charge will stimulate use of the PSTN. However, an expectation of increased use of the LCS by wholesale customers arising from a 32 per cent reduction in the wholesale charge (from 13.61 to 9.28 cents per call) is only partially offsetting and Telstra expects a significant net reduction in local calls made on its PSTN.

The ACCC notes Telstra's contention that the proposed substantial increase in PSTN access charges result from an expected declining use of PSTN services and reflect increasing unit costs since cost of the PSTN, including hypothetical efficient costs, are largely fixed.²⁷ In its model price determination for the core services released in October 2003, the ACCC did note that '...in future years there may be significant traffic migration away from the PSTN resulting in an increase in the per-minute call conveyance cost'.²⁸

The ACCC now notes that there is a sense in which an expectation of declining PSTN volumes may be self-fulfilling to the extent that an increase in future PSTN access prices directly or endogenously reduces demand to some degree. This said, the ACCC recognises that there are also exogenous factors influencing current consumer demand which are likely to continue to affect demand in the future for PSTN services and these need to be assessed and taken account of in forecasting future demand for PSTN services. Telstra's submission and media statement refer to a migration from fixed line services to mobile services and the greater use of broadband for internet and other (including the growing use voice over IP) services, rather than dial-up, as important drivers of declining PSTN product revenues.²⁹

²⁵ see paragraph 48.

²⁶ see paragraph 6

²⁷ see paragraph 8.

²⁸ see ACCC, *Final determinations for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p. 111.

²⁹ see paragraph 6 of Telstra's supporting submission and Telstra's Media Release, 'Telstra reduces wholesale local call prices', dated 22 March 2006.

The ACCC notes that volume forecasts will be an important element in the calculation of access charges for PSTN services that should apply in the future undertaking period.

Equally, however, with significant declines in PSTN usage in prospect over the next 2-3 years, it is not clear from Telstra's submissions to what extent its PSTN asset base has also been adjusted downwards to reflect the lower volumes that have been estimated that need to be carried. This also raises the issue of whether alternative services over an IP core will be increasingly used by Telstra and access seekers in the future to interconnect and obtain access to Telstra fixed line customers. If such services will provide essentially similar functionality to the declared services, then perhaps it is these services that should be the subject of real scrutiny, in terms of relevant costs and volumes, in the future. The ACCC expects this to become a more significant issue once existing core networks are upgraded to full IP/NGN functionality.³⁰

Questions for Submitters

Are Telstra's estimates of declining use of PSTN services appropriate?

Should alternative forecasts be used to calculate PSTN access charges?

To what extent should the PSTN asset base be commensurably adjusted to reflect the lower traffic volumes being assumed?

What services should be included in estimating traffic volumes on the IEN?

What costs and volumes will become relevant once core networks are fully upgraded to an IP basis and should these be taken into account in the pricing of future fixed access services?

Telstra's proposed "packaged" approach to the derivation of PSTN OTA and LCS charges

Telstra is proposing the PSTN OTA and LCS prices in the Undertaking as a package. According to Telstra, this package allows full cost recovery on a competitively neutral basis across both access seeker traffic and Telstra's own retail traffic and across all PSTN services. Telstra argues that it is not possible to assess the proposed price for LCS in isolation from the proposed prices for PSTN OTA, as the two are dependent on each other. According to Telstra, if it were determined that the LCS rate should be lower than proposed by Telstra, then the PSTN OTA rates would need to increase to ensure full cost recovery on a competitively neutral basis across all services, and vice versa.

Telstra has not proposed such a "packaged" approach in an Undertaking previously in such an explicit way and the ACCC has some concerns as to whether such an approach is consistent with TSLRIC which requires costs to be determined on a service basis rather than across different PSTN services.

³⁰ This aspect is also being considered in the current fixed services review.

Questions for Submitters

Is it appropriate to set prices for PSTN OTA and LCS as a package as proposed by Telstra?

If so what are the likely benefits to the industry and the end-user?

What are the likely impact of the proposed charges on future VoIP prices?

Issues associated with the structure of PSTN and LCS prices

Extent of averaging/de-averaging

The Undertaking PSTN OTA charges are structured such that only half of the contribution to the total IEN cost pool that is to be recovered is by way of de-averaged (per minute/call) charges, whereas previously all of these costs were recovered on a de-averaged basis. The reason given by Telstra for partial deaveraging of the rates is to reduce the per minute price in rural areas as compared to the charge that would otherwise apply if a fully de-averaged approach was adopted. For example, Telstra states the per minute rural charge for PSTN TA and PSTN non-preselect OA services would have to rise to 6 cents per minute compared to the 3.87 cents per minute using its proposed partial de-averaging.³¹ Even so, this rural charge is approximately three times the average per minute rate of 1.39 cents per minute in the metro area.

For PSTN TA and PSTN non-preselect OA this partial deaveraging is done by allocating half the cost (ie half of c-in-c) to all four Bands and deriving an average cost for all Bands. The other half is recovered as geographically deaveraged costs in each Band.

For the PSTN preselect OA service, Telstra proposes a geographically averaged fixed per customer fee of \$1.44 per month to meet 50 percent of this group's contribution to the IEN cost pool (c-in-c million in 2006/07)³² The per minute component charge is then deaveraged across the four geographic zones.

The Commission has not considered the issue of partial de-averaging and the use of a two part tariff of this kind in the context of PSTN OTA charges as Telstra's previous undertakings have included fully de-averaged charges. .

Questions for Submitters

Is it appropriate that Telstra set access charges on the basis of a partial de-averaged approach?

³¹ *ibid.*

³² see Telstra submission, paragraph 107.

What is the implications of such an approach on LTIE objectives of promoting competition and sending appropriate price signals for the efficient use and investment in existing and new networks?

Flagfall/per minute allocations

The PSTN OTA charges in the Undertaking are also structured such that 20 per cent of the total revenue raised by the charges comes from a flagfall element and 80 per cent from a per minute charge.

This approach is similar to previous PSTN charges. Telstra submits that this allocation was chosen for a number of reasons. Firstly, to ensure that access seekers requiring services with higher than average call times are not disadvantaged relative to access seekers acquiring services with lower than average call times. Secondly, a 20:80 revenue split accords with Telstra's retail pricing structure of PSTN services, in terms of the revenues raised from fixed line rental charges compared to variable time-based charges

In its Final Decision report on Telstra's November 2003 undertakings relating to the core services, the ACCC stated that a flagfall:per minute charge split of 25:75 for PSTN OTA charges, broadly reflecting Telstra's pricing of its PSTN retail products, was part of its preferred approach to determining reasonable access prices for PSTN access services.³³ It was thought that this pricing principle would assist to ensure that there would be no undue bias toward or away from wholesale or access seeker provision of PSTN services vis-a-vis Telstra retail provision of PSTN services.

Questions for Submitters

Is Telstra's proposed pricing structure with respect to its flagfall and per minute charge elements appropriate?

PSTN OA Two-Part Tariff

Telstra has proposed a two-part tariff on PSTN OA where that traffic belongs to the same access seeker that is the pre-selected carrier. The PSTN OA Undertaking proposes:

- A \$1.44 and \$1.48 monthly charge for each customer for 2006/07 and 2007/08 respectively; and
- A headline rate of \$0.0119 per minute and \$0.0124 per minute for 2006/07 and 2007/08 respectively.

Further in determining the allocation between the fixed monthly charge and the per minute charge, Telstra allocates these charges on a 50:50 basis arguing on what it believes is a reasonable structure for these charges.

³³ see *Assessment of Telstra's undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004, p.45.

By contrast for PSTN TA and non-preselected PSTN OA Telstra proposes a headline rate of \$0.0218 per minute and \$0.0228 per minute for 2006/07 and 2007/08 respectively, which is double the rates of originating access charges which incorporate a fixed charge.

Telstra submits that implementation of a two-part tariff structure where appropriate will improve efficiency. It argues that the efficiency benefits of a two-part tariff are the result of lowering the variable component of the price toward variable costs encourages more efficient use of the PSTN.

The ACCC has not examined the issue of two-part tariffs in respect to PSTN services in the in any detail in the past. Nevertheless, the Commission wishes to draw attention to a number of possible issues that may arise:

- A fixed monthly charge per customer may disadvantage access seekers whose customers base is composed of mainly low volume users as the fixed monthly charge is spread over low volumes of usage
- A fixed monthly charge per customer on PSTN OA is not consistent with existing retail prices for long distance services
- The proposed structure will imply a different access pricing structure for preselected PSTN OA as compared to PSTN TA and non-preselected PSTN OA and it is not clear that this is in the best interest of end-users.
- Implications for network to network competition; mobile/fixed competition and convergence
- Implications for ULLS-based competition
- Implications for competition from VoIP services?

Questions for Submitters

Will end-users benefit from the proposed PSTN OA two-part tariffs

What would the impact be on access seekers

Is a fixed monthly charge per customer on PSTN OA consistent with existing retail prices?

Is Telstra 50:50 allocation of fixed charges versus minute charges for preselected PSTN OA reasonable? If not, why not?

Are there any issues associated with charging different access prices for preselected PSTN OA versus PSTN OT and non-preselected PSTN OA.

Is the two-part tariff based on Ramsey pricing principles designed to maximise efficient outcomes?

Retail Minus Retail Cost (RMRC) for LCS

The proposed LCS charge in the Undertaking is based on the application of a Retail Minus Retail Cost (RMRC) pricing principle where the starting point is Telstra's unbundled local call price of 22 cents per call (or 20 cents per call excluding the GST) for non-preselected end users.

Telstra also states that its estimate of retail costs, or the local call and basic access costs it avoids in supplying the LCS to wholesale customers, is based on an approach consistent with the Commission's previous views on pricing methodology.

The Commission's most recent draft determination on LCS pricing has provisionally recommended the continuation of a RMRC pricing principle, albeit as an interim approach in the absence of a cost model (other than PIE II) suitable for determining a TSLRIC-based price for the LCS.³⁴ The Commission observed that the conclusions underlying the continued use of RMRC as an interim approach are finely balanced, and heavily dependent on the relativity between retail prices and costs.

The LCS draft determination unequivocally states that RMRC prices are to be unbundled, and that as a result the RMRC discount on basic access is no longer to be applied to local calls. The Undertaking, however, does not reflect these principles.

Questions for Submitters

Is the RMRC pricing principle an appropriate basis for setting the LCS undertaking charge?

Is an alternative cost-based approach viable for setting charges for the undertaking period?

Is Telstra's application of the RMRC pricing principle and its use of regulatory account data appropriate?

Non-price terms and conditions

Telstra's undertaking does not purport to cover matters other than pricing³⁵ nor is it intended to be exhaustive of all matters relating to supply of the declared services.³⁶

The undertaking clauses relating to terms and conditions other than price are no different from those approved by the ACCC in December 2004. As that time, the ACCC did not identify issues of concern relating to non-price matters for the PSTN O/TAS and the LCS. The ACCC therefore does not seek to highlight any issues with respect to non-price terms and conditions of access.

Consistency with SAOs

Telstra's undertaking includes Attachment G, obliging Telstra to treat access seekers on a non-discriminatory basis, as required by its SAOs with respect to the declared services covered by the undertaking.

³⁴ see ACCC, *Local Services Review*, March 2006, p. 100-102.

³⁵ see Recital C(a).

³⁶ see clause 3.2(a).

The undertaking clauses relating to the supply of the declared services, except with respect to price terms and conditions, are no different from those approved by the ACCC in December 2004. At that time, the ACCC did not identify concerns with respect to the undertakings being inconsistent with Telstra's SAOs.

The ACCC therefore does not seek to highlight issues of concern with respect to the undertaking being consistent with Telstra's SAOs.