

Annexure D

iiNet, Submission on draft ULLS pricing principles and indicative prices

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iiNet Ltd

PUBLIC VERSION

1. Introduction

iiNet is very appreciative of the significant amount of work undertaken by the ACCC to reach the position of publishing ULLS pricing principles and indicative prices. By promoting competition, this work is vital to participants in the telecommunications industry and to the interests of Australian consumers.

iiNet acquires access to the ULLS from Telstra and actively intends increasing the number of services it acquires. As such, iiNet's business plans are closely impacted by the ACCC's ULLS pricing principles and indicative prices. iiNet's experience to date is characterised by repeated failure in negotiating reasonable terms of access with Telstra, resulting in access terms being determined via ACCC arbitration. We consider it highly likely that the same situation applies across the board to all access seekers and that it will continue for as long as Telstra declines to participate in any form of commercial negotiation. In this light, the ACCC's position will determine iiNet's, and other ULLS acquirers', key ULLS cost inputs going forward.

iiNet supports the ACCC's view that:

- During the period of these pricing principles and indicative prices it remains appropriate to use a Total Service Long Run Incremental Cost (TSLRIC) pricing principle for the ULLS; and
- ULLS charges should be geographically de-averaged.

iiNet agrees it is appropriate to include a specific cost component in ULLS monthly charges, but considers that the pooling allocation should be broadened to include costs for all services using Telstra's CAN.

iiNet agrees that connection charges should be based upon third party contractor rates but has considerable concerns that the quotes provided by Telstra and utilised by the ACCC do not represent quotes that would be obtained via a competitive tendering process.

2. General approach to indicative prices and cost modelling

We agree that Telstra's TEA model needs to be vigorously tested before its application to network costing can be assessed, even within the model's Band 2 parameters. Though we understand the ACCC's predicament in that it does not currently have an alternative cost model with which to compare Telstra's PIE II or TEA models, we have ongoing and significant concerns regarding the Commission's 'conservative approach' in applying the PIE II model in assessing network costs. Both the ACCC and the Australian Competition Tribunal, along with access seekers, have repeatedly expressed the view that PIE II contains inbuilt operational impediments, usage difficulties, and a tendency towards overestimating costs, that unfairly weight the resulting costs upwards. This results in outputs and network cost estimations

that do not reflect efficient costs, with monthly charges being subsequently set at too high a rate - giving Telstra too high a return and an unreasonable advantage over its wholesale customers/competitors.

iiNet has previously supported the ACCC's use of a TSLRIC costing methodology. The alternative, of basing access prices upon Telstra's historical or current costs with large margins for inefficient practice, was clearly unappealing on the basis that it would result in higher access prices that would hinder competition and entrench inefficient use of valuable infrastructure. However, we do have concerns about the manner that TSLRIC is applied when costing Telstra's legacy CAN. In particular, basing network costs upon the cost of installing a new network, even if the new network is installed in as efficient a manner as possible, appears to be a flawed concept when the reality is that the existing network utilised by the ULLS was installed many years ago at taxpayer expense and has subsequently been paid for many times over by Australia's millions of fixed services customers. Following Telstra's unsurprising High Court loss, commentators pointed out that ignoring the High Court's history lesson risks giving returns to Telstra's shareholders that are inconsistent with their reasonable entitlements.¹ These commentators argued that ignoring regulatory history, which impacted the value of Telstra's assets, and promoting forward looking concepts, ignores the fact that installing a network today would be considerably more expensive than installing a network in the past.

This argument is not based upon the real value of money over time, but rather on the physical reality of building a network in green-field sites, without having to trench through driveways, bore beneath roads, or replace lawn, footpaths and gardens that had yet to be constructed. A significant amount of past network costs have been borne by property developers and not by Telstra or its predecessor, and should not be borne by the hypothetical builder of the new network. The reality is that telecommunications networks are usually built prior to or as part of developments rather than as an expensive after thought. Forward looking network cost analysis should reflect this reality.

Further, given that the CAN has been paid for and fully depreciated, there is a strong argument that the TSLRIC of network costs should only account for efficient O&M costs.

We consider it important that a degree of certainty be set in ULLS pricing. As the current pricing principles and indicative prices are intended only to apply until 1 July 2009, for the current purposes we support the continued application of TSLRIC, but stress that in light of the High Court's judgement, this approach should be seriously reconsidered during the ACCC's future assessment of network costs.

3. Specific costs

We agree that monthly charges should include an allowance for costs associated with ordering, provisioning and qualifying a ULLS.

Whilst iiNet supports the Commission's proposed approach to pool the 'specific costs' associated with (i) the ULLS, and (ii) the LSS, and (iii) Telstra's own internal ADSL costs, iiNet considers that the pooled cost base should be allocated across all copper lines, rather than ADSL lines only. This is because the ULLS can be used to provide both ADSL and telephony and other telecommunications services and

¹ Ockerby, J, *Competition Economists Group - High Court says history is important*, 10 March 2008

therefore all customers accessing the CAN will benefit from ULLS price competition. The point, regarding the potential importance of the ULLS for telephony, does in fact seem to have formed the basis of the Commission's recent draft decision to provide Telstra with exemptions from its WLR/LCS obligations in ESA's with a certain level of ULLS-based competition.

A broader application of cost pooling has previously been endorsed by the Commission in its assessment of Telstra's ULLS Monthly Charge Undertaking:

There are strong reasons for believing that the ULLS will have an impact on both ADSL and telephony prices. First, it is likely that ULLS access seekers will provide both voice and broadband. Given the low incremental costs of providing a voice service once DSLAMs are installed and IEN arrangements made, it seems that ULLS access seekers will use the technology to provide voice even to customers not currently taking ADSL. Second, ULLS will allow a greater competitive impact through VoIP even if access seekers do not provide a traditional voice service. Consequently, the potential to switch lines between carriers created by the ULLS service leads to lower consumer prices and increased quality of all telephone services, it seems clear that the beneficiaries are all consumers using the CAN. Consequently, this regulatory criterion would indicate that all consumers connected to the CAN should contribute to the ULLS-specific costs.²

This broader application of pooling was also supported by the Australian Competition Tribunal in its assessment of Telstra's ULLS undertaking.³

iiNet notes that, whether costs are allocated across all copper lines or ADSL lines only, Telstra's legitimate commercial interests will still be met. That is, because a WACC component is included in the ULLS specific costs, Telstra will still be able to recover its costs, including the direct costs associated with the ULLS, and a normal return on its capital employed.

If Telstra's costs are adequately recovered under the approach of allocating costs across all CAN lines, it follows that the approach of allocating costs across ADSL lines only will enable Telstra to recoup an above normal return on its investment in ULLS. This appears contrary to the view, expressed in the Commission's previous ULLS Pricing Principles, that:

...it is unlikely the legitimate business interests extend to achieving a higher than normal commercial return through the use of market power.⁴

4. Application of cost model

The Commission has taken a conservative approach in assessing Telstra's network costs, which we consider unnecessarily favours Telstra. Telstra's PIE II model has been subject to regular criticism by Access Seekers, the Commission and the Australian Competition Tribunal, with the following concerns still being relevant:

- The cost implications of spare capacity seem to be overestimated;
- It is unclear whether the historic O&M costs that are used in the model reflect efficient costs;

² ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings – Final Decision*, December 2005, pp.54-55.

³ Australian Competition Tribunal, *Telstra Corporation Ltd (No. 3) [2007] ACompT3*, paragraphs 396 - 411

⁴ ACCC, *Pricing of unconditioned local loop services (ULLS) - final report*, March 2002, p.13.

- Telstra may be over-recovering network planning costs by also recovering these costs under O&M expense factors;
- The Commission's proposed value of 13 per cent of trenches available for sharing may understate historical trench sharing;
- The lack of clustering algorithms, the use of rectilinear distance estimation and the use of minimum spanning trees in the PIE II model may lead to an overestimate of the required lengths of cable and conduits in the network;
- The asset lives used in the annualisation of capital costs appear to be based on accounting measures that may not represent economic asset life; and
- The PIE II model overestimates costs in regional and rural areas (which will affect the prices generated for band 3).

iiNet does not believe that it is appropriate for Telstra to continue reaping returns exceeding efficient costs by the Commission taking a conservative approach in applying the PIE II model to costs. Whilst iiNet accepts that, until its own cost model is developed and perhaps until the TEA model is tested, PIE II remains the only model available to the Commission, iiNet believes that the Commission should make an allowance for each of its concerns by applying an appropriate deduction to the cost estimates produced by the PIE II model.

5. Particular cost model inputs - *Trenching*

A carrier's right to install low-impact telecommunications facilities, such as underground cables, is provided by Schedule 3 to the *Telecommunications Act 1997*. This allows carriers to dig trenches and install cables without permission from local councils, state planning bodies or even affected land owners. Amongst the conditions imposed on carriers exercising their installation rights, is the obligation to comply with a Ministerial Code of Practice.⁵ The relevant Ministerial Code is the *Telecommunications Code of Practice 1997*, which amongst other things provides as follows:

4.13 Co-location

- (1) Before engaging in a low-impact facility activity, a carrier must take all reasonable steps to find out whether any of the following things (*existing facilities*) is available for the activity:
 - (a) cabling, conduits or other facilities of the carrier or another carrier; or
 - (b) a facility of a public utility; or
 - (c) an easement attaching to the land for a public purpose.
- (2) The carrier must take all reasonable steps to use existing facilities for the activity.

⁵ *Telecommunications Act 1997*, Schedule 3, clause 15.

4.14 Cooperation about activities

Before engaging in a low-impact facility activity, a carrier (the *first carrier*) must take all reasonable steps:

- (a) to find out whether another carrier, or a public utility, is engaging in, or proposing to engage in, a similar activity for the same land; and
- (b) to consider whether it is practicable to work with the other carrier or the utility to allow the first carrier:
 - (i) to cause as little detriment and inconvenience as is practicable; and
 - (ii) to do as little damage as is practicable.

Note The carrier is required to take all reasonable steps to ensure that the carrier causes as little detriment and inconvenience, and does as little damage, as practicable in engaging in the activity: see Act, Schedule 3, clause 8.

Clearly, Telstra and all other carriers have a statutory obligation to take all reasonable steps to share trenches constructed for the installation of cables. The reasoning behind this is that the community does not like its streets being repeatedly dug up to install cables, pipes and other infrastructure. Further, it is a gross waste of funds to not share trenches wherever possible. It stands to reason that the detrimental effect and cost of open trenches will be minimised if carriers and utilities such as water, gas and electricity providers actively engage in sharing trenches. We consider that if, historically, Telstra did make all reasonable efforts to share its trenches, the percentage of shared trenches would be vastly higher with correspondingly lower resulting network costs. In terms of forward looking costs, it is imperative that this statutory obligation, with great potential to lower costs, is taken into account and enforced.

Further, in its submissions to the Commission in support of its transmission exemption application, Telstra claimed that its competitors have installed significant amounts of fibre in the relevant Band 1 and 2 ESAs. For example, Telstra claimed that the average number of fibre owners in CBD ESAs was 7.2 in Sydney, 7 in Melbourne, 3.75 in Brisbane, 6 in Adelaide and 4 in Perth.⁶ Telstra claimed that this large amount of competitive fibre in these ESAs establishes there is a sufficient level of competition that the service need not remain declared. If this competitive fibre exists, then surely any forward looking efficient network planning would ensure that it is installed in the same trenches, in order to minimise community detriment and carrier cost. On this basis and relying solely on Telstra's claims, it would appear that the sharing of trenches in Bands 1 and 2 would approximate towards 100% rather than the 1% proffered by Telstra or the 13% suggested by the Commission.

6. Structure of charges

The Commission stated that it rounded up the monthly charges to the nearest ten cents when transferring the figures from its cost model to its proposed charges. iiNet considers that this is highly inappropriate and there is absolutely no reasonable basis for the Commission to apply charging structures that are unfairly favourable to Telstra as opposed to access seekers that are trying to compete with Telstra. iiNet acknowledges that the charges proposed by the Commission are a significant improvement on the current charges imposed by Telstra, however, iiNet considers it

⁶ Telstra, *Submission to the ACCC, Telstra's Domestic Transmission Capacity Service Exemption Applications, Supporting Submission*, December 21, 2007, pp 10 - 11.

is imperative that ULLS charges reflect the costs of an efficient operator. Though this rounding up only concerns several cents in relation to each service in operation or connection, should iiNet proceed to connect a large number of ULL services, it will lead to a material sum of money when extrapolated across all services in operation each month. This amount is even more significant when extrapolated across the services of all ULLS acquirers.

Where the Commission allows Telstra to retain fat in its charges, it is merely allowing Telstra to reap higher charges and have an unfair advantage over its competitors. iiNet submits that this is contrary to the criteria specified in s.152CR(1)(d), which provides that the Commission must have regard to direct costs in making a final determination. This is particularly relevant as s.152AQA(6) provides that the Commission must have regard to determined ULLS pricing principles when arbitrating a ULLS access dispute. Rounding up is arbitrary and cannot be described as reflecting direct costs. As such, it is not a suitable practice for the Commission to follow in setting indicative prices as it will subsequently place the Commission in the undesirable position when finalising an access dispute of having to either deviate from its indicative prices or its obligation to have regard to the direct costs of providing the ULLS. Further, given the Commission's view that the conservative position it has taken in accepting Telstra's approach to provisioning, O&M, network planning and network design will result in a higher estimate of network costs than would otherwise be the case⁷, it is clear that rounding the charges down rather than up would result in a more accurate costs assessment.

7. Back of house costs

iiNet agrees that Telstra is entitled to recover its back of house costs for ULLS connections and managed network migrations. However, iiNet considers that the Commission's proposed annual labour cost of \$60 to \$64 per hour, or \$117,000 to \$124,800 per annum, is far too high.

iiNet submits that iiNet's Customer Service Representative role is directly comparable to the role performed by Telstra's back of house staff, such as the DAC. As set out in the attached Individual Transitional Employment Agreements the base rate for an iiNet Permanent Full Time Customer Service Representative is \$36,000. This rate increases up to a maximum of \$42,000 for Customer Service Representative roles involving a high degree of experience, skill and responsibility. Once a further 21% is added for on costs such as superannuation, payroll tax and workcover, the total annual labour cost of these staff members ranges from \$43,560 to \$50,820.

[Confidential section begins]

Confidential survey of telecommunications industry salaries supports iiNet's submissions of appropriate labour costs.

[Confidential section ends]

8. Time needed for DAC activity

The activities included in the Commission's assessment of a ULLS connection include tracing bad/missing cable records and other manual service qualification tasks. iiNet considers that this demonstrates the unfortunate mix of historical costs that have crept into ULLS costing. Carriers have a statutory obligation to keep and maintain accurate records of all underground cables and facilities.⁸ It is simply not

⁷ ACCC, *Draft Unconditioned Local Loop Service, Pricing Principles and Indicative Prices*, April 2008, p 12.

⁸ *Telecommunications Act 1997*, Schedule 1, clause 41(3) and (4)

reasonable that access seekers are penalised by having to pay higher connection charges as a result of Telstra's failure to adhere to its statutory obligation. This is particularly evident when connection charges are supposed to be based on the costs of an efficient operator. An efficient operator would surely take adequate care to ensure that it knows where its cables are installed and whether they are of adequate condition or technology to support an ADSL service.

9. Material costs and mark-up for indirect costs

iiNet accepts the Commission's view to adopt a mark-up of 10% to cover indirect costs.

10. Weighting of singular and multiple jumpering charges

iiNet agrees that the vast amount of jumpering work regularly undertaken in CBD exchanges means it is very unlikely singular jumpering will ever occur. Similarly, the high levels of work in metropolitan exchanges, not merely confined to ULLS connections, would provide an ample opportunity for tickets of work for contractors to be batched so that multiple jumpering quotes would almost always apply. iiNet accepts that there will be occasions when singular jumpering may occur in Band 2 metropolitan exchanges, but considers that this would be more likely to be in the region of only 10% to 20% of the time in metropolitan exchanges. iiNet considers that the Commission's estimate that singular jumpering would account for 80% of connections in Band 3 regional exchanges is likely to be reasonably accurate.

11. Appropriate contractor quotes to use

The fact that Telstra's ULLS quotes exceed LSS quotes demonstrates the main problem in relying upon third party contractor rates to set ULLS connection charges, i.e. there is simply no incentive for Telstra to obtain competitive quotes for the work as the charges are simply passed on to access seekers. Rather, the higher rates are in Telstra's favour, as higher connection charges act as a disincentive to end-users that are considering transferring to the ULLS.

It simply makes no sense for ULLS jumpering costs to exceed LSS jumpering quotes. As the Commission is aware, ULLS jumpering involves a single pair of wires, compare to two pairs needing to be jumped when connecting an LSS. As such, ULLS contractor costs should be lower, not higher, than LSS rates. Despite Telstra's claims, we consider that PSTN connection quotes do provide a fairer estimate of costs than the ULLS quotes provided by Telstra. Further, we consider that the only current manner in which to ensure that Telstra actively seeks competitive ULLS connection quotes, and hence efficient costs, is to give it a financial incentive by linking ULLS rates to PSTN rates, such that it is in Telstra's interests to obtain contractors that will perform the work at reasonable rates.

Alternatively, if PSTN rates are not to be used, then contractor quotes obtained for LSS connections should at least be used in order to bring ULLS connections somewhat closer to realistic efficient costs.

12. Disconnections

We agree with the Commission's view not to impose a disconnection charge.

13. ULLS Managed Network Migration charges

The concerns that we have raised above in relation to ULLS single connections are also relevant to MNMs. Telstra's current refusal to implement an efficient LSS to ULLS transfer process has proven to be extremely detrimental to iiNet's ability to migrate LSS customers to the ULLS. We are of course aware that the Commission has ordered Communications Alliance to develop an LSS to ULLS transfer process, however we consider that it would be very helpful if the indicative prices confirmed LSS to ULLS migration charges.

14. ULLS call diversion charges

Though iiNet understands that the processes for activating and terminating call diversion are largely automated, we consider the Commission has proposed a reasonable methodology by basing call diversion charges upon the time taken for ULLS call diversion activities by DAC staff multiplied by its assessment of an appropriate hourly salary.

It is in Telstra's commercial interest to provide a diversion service as it increases the number of successfully completed calls, for which Telstra will generally earn revenue. Calls which do not complete are not charged for.

We consider that Telstra should not be permitted to apply an on-going call diversion charge, because Telstra does not incur ongoing costs to maintain automated routing instructions for call diversion. Any costs associated with this automated process are recovered via network costs applicable to the ULLS and other services.

We note that paragraphs 2.10 and 3 of the Commission's discussion paper, and paragraph 4 of the unsigned Pricing Principles for the Unconditioned Local Loop Service Amendment Determination 2008 (No.1) refer to different prices for call diversion connection charges in 2007/08. We request that the Commission check this and ensure that its final Determination includes the correct rate, which we submit should be \$8.80 rather than \$9.20.

14. Other matters

Pricing principles and indicative prices are only of assistance to access seekers to the extent that the access seekers are able to take advantage of them. iiNet is currently extremely frustrated by our inability to migrate customers to the ULLS.

iiNet has approximately 148,838⁹ customers on LSS that it could migrate to a ULLS based product at some time, but the lack of a migration process means these customers are stuck on LSS.

In respect of migration to ULLS, the biggest single blocker in this migration path is Telstra. Mass migration to ULLS from LSS remains almost impossible. Telstra has no process for such migrations and discussions with Telstra do not provide any idea of when this may be rectified. The only option for an existing customer to be migrated to a ULLS based service is for the customer to cancel their service, have the LSS disconnected and then re-apply as a new customer. This situation is clearly untenable. Access seekers, such as iiNet, simply cannot expect customers to accept disconnection of their service for a period of up to three weeks while awaiting

⁹ http://www.iinet.net.au/about/investor/20080508_westnet_acquisition_investor_presentation.pdf

for the ULLS to be connected. The risk of customers transferring to a different service provider in the meantime is too high to contemplate.

This means that ULL based services can only be offered to new customers while LSS based services must remain on the LSS. However, the market is clearly approaching saturation. iiNet estimates that 70% of its customers churn from existing ADSL providers and there are very few 'new' customers in the market. As a result, access seekers need migration processes that are efficient and automated, in order to move customers on to the ULLS.

The ACCC has previously expressed support for the 'stepping stone' or 'ladder of investment' model of telecommunications regulation, where industry participants are encouraged to move up the 'ladder of investment' towards full facilities-based competition'.¹⁰ In order to progress up the ladder of investment, it is important to have the steps in place. By including the LSS 'step', smaller investors are able to build scale, develop skills and build profitability. However, Telstra's refusal to develop techniques and processes for the cost-effective migration of services from the LSS to ULLS acts as a serious impediment to investors taking the next step.

In addition to formulating pricing principles and indicative prices in relation to ULLS pricing, iiNet requests that the ACCC monitor Communications Alliance's development of a LSS to ULLS migration process to ensure that access seekers are able to fully utilise the ULLS going forward. In the event that Communications Alliance's code development is in any way hampered, iiNet requests that the Commission utilise its power to take whatever steps are required to implement a code without further delay.

iiNet
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¹⁰ ACCC, *Fixed Services Review - A second position paper*, April 2007, p20.