TELSTRA ULL PRICE UNDERTAKING

A bit of history, reality and common sense needed in telecommunications regulation

On 13 November 2008, the ACCC issued an important draft decision on the pricing of the unbundled local loop (the copper access line into the home which carries telephony and broadband services). In rejecting the proposal from Telstra to charge $30 per line per month to its competitors the ACCC signals what may turn out to be a fundamental change in the price regulation of monopoly telecommunications networks. The ACCC flags a potential move away from the 'dogma' of forward-looking costing concepts to an approach which takes into account some relevant history, the reality of operators' decision making, and quite a bit of common sense.

Historically, the ACCC has largely relied on estimates of forward-looking replacement costs to update the valuation of Telstra's assets. For example, the price for access to the unbundled local loop was based on models which value the lines at the cost of replacing them today. This values copper lines that were laid decades ago on the basis of what it would cost to dig a trench and lay copper cable today.

Telstra employed such a model to support its pricing proposal. These models adopt the so-called 'hypothetical new entrant' paradigm. This paradigm is justified on the basis that it sends efficient 'build/buy' decisions to access seekers – such that they only bypass the local loop (say, by building their own cable networks) if they can do it cheaper than a 'hypothetically efficient new entrant'.

CEG economists have always maintained that this justification is of dubious merit – not least because new entrants into the provision of natural monopoly services were (by definition) unlikely and would never enter with the types of technology being modelled (eg, new trenches laid with copper cable). In 2003, Dr Tom Hird advised the ACCC that:

> *"... the justification for using TSLRIC (or TSLRIC+) is not related to setting efficient build/buy decisions but is best justified on the grounds of providing for dynamic efficiency in the incumbent's future investments"*

In its 13 November draft decision, the ACCC now appears to be stepping away from the 'new entrant' paradigm:

> *"the ACCC acknowledges that the past rationale of promoting efficient build/buy decisions through the application of TSLRIC+ may be less relevant in a regulatory environment where the competitive state of telecommunications markets is changing and there may be fewer prospects for efficient by-pass."*

The ACCC's move is consistent with policy changes by regulators around the world including Europe's leading economic regulator, OFCOM. Whilst some time coming, this move is important because it prevents some regulatory debates in Australia from going down what CEG has previously described as 'Alice in Wonderland' hypothetical rabbit holes.

For example, as CEG reported back in March 2008, Telstra and the ACCC appeared to have historically agreed that the 'new entrant' paradigm required one to value Telstra's trenches on the basis of the cost of re-digging those trenches – even though many trenches were dug by a developer and Telstra was given free access to them.

However, in this draft decision some reality and commonsense has prevailed with the ACCC stating that:

> *"... Telstra did not incur trenching costs of the same magnitude as those modelled in the TEA model [Telstra's forward looking model] since, for example housing estate developers excavated many of the trenches which Telstra use. Therefore by allowing Telstra to include these cost as part of the TEA model would result in Telstra being compensated for costs that it (in most cases) never incurred and is not likely to incur within the economic life of the existing copper pairs."*

In addition, this change in paradigm means that the ACCC can more directly answer some of Telstra's other claims. These include Telstra's claim for a higher weighted average cost of capital (WACC) to ensure the future viability of the network. Telstra contends that setting the WACC even a little too low could cause a capital strike. If we think purely inside a 'hypothetical new entrant' framework such arguments have potential significance as regulatory error in setting the WACC too low can have important consequences for new investment. However, reflecting on reality the ACCC correctly note that:

> *"... given the sunk nature of the investment in the CAN, the ACCC believes Telstra should have a strong incentive to continue investing in maintenance at least sufficient to provide the current ULLS service."*

CEG economists have been involved early in this debate as well. In 2005, Mr Jason Ockerby recognised that:

> *"A large proportion of the capital invested in the ULLS network is sunk. This means that the investment decision in relation to these assets is irreversible (by definition) and therefore the effect of an additional return on capital in the regulated WACC will not affect the decision of whether or not to invest. Thus, the only relevant risk to investment is that which relates to maintaining and incrementally expanding the existing network."*

However, it must be understood that the ACCC is only signalling a potential shift in the telecommunications regulatory framework. The ACCC draft decision contains many inconsistencies and lacks clear guidance on an appropriate regulatory model and framework. It is one thing to acknowledge the unsatisfactory conceptual basis for the new entrant paradigm – it is another to propose a set of alternative principles for the ACCC to rely on. There is more conceptual thinking to be done, and it is far from clear where this potential change in direction will lead access pricing debates, particularly with developments on the National Broadband Network.

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