Australian
Competition &
Consumer
Commission

Local Services Review

Final Decision

July 2006

Table of contents

Abbreviations

AAPT	AAPT Limited
ACCC	Australian Competition and Consumer Commission
ACN	Australian Communications Network Pty Ltd
CAN	Customer access network
CCC	Competitive Carriers Coalition
Discussion paper	ACCC, *Local Services Review 2005*, April 2005.
Draft decision	ACCC, *Local services review—draft decision*, March 2006.
xDSL	Digital subscriber line
IDD	International Direct Dial
LAS	Local access switch
LCS	Local Carriage Service
LTIE	Long Term Interests of End–users
Macquarie	Macquarie Telecom Pty Ltd
Optus	SingTel Optus Pty Ltd
PIE II	PSTN Ingress and Egress model, version 2
POI	Point of interconnection
Primus	Primus Telecommunications Pty Ltd
PSTN	Public Switched Telephone Network
PSTN O/T	PSTN Originating and Terminating Access Services
RMRC	Retail-minus-retail-costs
SAOs	Standard Access Obligations
SPC	Southern Phone Company
STD	Subscriber Trunk Dialling
Telstra	Telstra Corporation Limited

TPA	*Trade Practices Act 1974*
TS	Transit switch
TSLRIC	Total service long-run incremental cost
TSLRIC+	Total service long-run incremental cost plus indirect costs
ULLS	Unconditioned Local Loop Service
USF	Universal Service Fund
USO	Universal service obligation
VoIP	Voice over IP
WLR	Wholesale line rental

Glossary

Access Provider	Carrier or carriage service provider who supplies declared services to itself or other persons. Defined in s. 152AR of the TPA.
Access Seeker	Service provider who makes, or proposes to make, a request for access to a declared service. Defined in s. 152AR of the TPA.
Customer access network	The network which enables the connection of telephones and other customer premises equipment to switching technology. It consists of a network of conduits and pipes in the ground with a mixture of cables containing copper wires and optical fibres. It has two parts – the distribution network and the feeder network.
Distribution network	That part of the customer access network connecting the distribution point (typically a pillar) to the network termination point.
Exchange	A generic term for a major node in an exchange service area (e.g. an IRIM, RSS/RSU, LAS, TS).
Exchange Service Area	A part of the feeder network connected to a given exchange.
Feeder network	That part of the customer access network connecting the exchange to the distribution point (typically a pillar).
Local access switch	This equipment provides ring current, dial tone and battery feed to end-users, as well as switching calls locally to other local access switches. It also provides number analysis for call routing and call charge recording, and enhanced (or supplementary) services such as call waiting and call diversion.
Pre-selection	Function that enables an end-user or service provider to select a preferred carrier or carriage service provider for a certain type of call (e.g. long distance calls).
Service provider	A carriage service provider or a content service provider. Defined in s. 86 of the *Telecommunications Act 1997*.
Total service long run incremental cost	Discussed in ACCC, *Access Pricing Principles – Telecommunications: A guide*, July 1997.

1 Summary

In April 2005, the Australian Competition and Consumer Commission (ACCC) commenced its Local Services Review. The review was commenced to examine a range of issues relating to whether the local carriage service (LCS) declaration should be continued, including whether to declare a line rental service.

The ACCC released a draft decision in March 2006. That decision proposed to continue the declaration of the LCS for a period of two years, and to declare a wholesale line rental (WLR) service for two years.

This report is the ACCC's final decision. The ACCC has decided to:

- continue the declaration of the LCS for three years
- declare a WLR service for three years
- price the two services using an interim retail-minus-retail-costs pricing approach but seek to implement a cost-based pricing approach once a robust cost model is available.

Market analysis

The ACCC conducted an extensive assessment of the appropriate definitions of markets related to the supply of the LCS and WLR. It found that, outside of the CBD areas of the major cities, there are no widespread effective substitutes for either the LCS or WLR. This has implications for competition at both the wholesale and retail level. The ACCC also found that the two products should be seen as separate products.

However, there are sufficient alternatives to the LCS and WLR local services in certain CBD areas to provide a constraint on Telstra's prices for those two services in those areas. These alternatives include competing infrastructure and the unconditioned local loop service (ULLS).

The ACCC also found that there is considerable uncertainty about the development of competitive infrastructure platforms and services, such as wireless access, fixed-to-mobile substitution, VoIP and the ULLS, that could act as supply substitutes to the LCS and WLR services. Currently these services cannot be considered to be effective substitutes outside of the CBD areas. However, given the speed of technological change and uncertainty regarding take-up of alternatives to Telstra's wholesale services, it is difficult to be definitive about substitution trends beyond a two year period.

Decision to continue declaration of the LCS

The ACCC considers that the continued declaration of the LCS is likely to promote the long-term interests of end-users by both promoting competition and encouraging the economically efficient use of and investment in infrastructure.

There is currently no widespread facilities-based competition to Telstra's LCS and, in the near future, service providers resupplying Telstra's services are likely to be the main source of retail market competition for local telephony services. The ACCC considers that, without declaration, access seekers may be unable to get access to the LCS or to do so on reasonable terms. Continued declaration of the LCS would mandate access on reasonable terms and constrain Telstra's ability to influence competition in the retail local telephony market. Declaration will also promote competition in the long-distance telephony market where local telephony services are bundled with long-distance calls for end-users who prefer a single provider.

Continued declaration of the LCS under current market conditions is also likely to encourage efficient investment in infrastructure used to supply local telecommunications (and possibly other) services. It will continue to facilitate market entry and enable service providers to obtain information about demand characteristics and the likely responses of competitors. This information will reduce the risks associated with infrastructure deployment and thereby promote ULLS and other facilities-based provision. Service providers will be able to make efficient decisions about when to deploy customer access infrastructure. Similarly, Telstra's incentives to efficiently invest in replacement technologies to deliver voice services will not be unduly affected by declaration as long as the pricing approach does not lead to either under-recovery (which would reduce its capacity to invest in new networks) or over-recovery (which would reduce its incentive to invest in more efficient technologies) of costs.

Decision to declare the WLR service

The second issue examined during the review was whether a line rental service should be declared. As a result of the access arrangements and pricing for the LCS, the WLR service has been implicitly declared as part of a bundle with local calls since 1999. However the ACCC considers that there are strong reasons justifying the independent, explicit and transparent declaration of WLR as a separate service.

Line rental is an essential input for the provision of both voice and data services. Tying the line rental service to particular downstream services inhibits an access seeker's ability to compete with Telstra on a resale basis as the reseller is unable to differentiate the price or quality of the service. As such, resellers are effectively forced to pass on the regulated bundled price.

The ACCC considers that formally declaring a separate line rental service would promote competition in downstream retail markets by providing greater certainty to access seekers on the provision and pricing of this service. It will also enable the line rental service to be used to provide other services rather than just as part of a bundled voice-access service.

The ACCC also considers that, as with the continued declaration of the LCS, that the line rental declaration will encourage economically efficient use of and investment in infrastructure. The declaration will encourage service providers to find lower-cost ways of producing retail services, and will allow access seekers to obtain market information and establish scale that will allow infrastructure build. Increased competition will provide Telstra with incentives to invest efficiently.

Length of declaration

The ACCC noted above that there is currently considerable uncertainty about the likely take-up of alternatives to Telstra's wholesale local services, but considers that a significant level of the uncertainty around network and service alternatives is likely to have been resolved after two years.

The ACCC must commence a review of any declaration within the 12 month period prior to the expiry date. The ACCC therefore considers that it would be appropriate for the declarations to apply for three years from 1 August 2006 until 31 July 2009. A three year declaration period will mean that, at the commencement of the next review of these declarations, the currently uncertain state of competition and infrastructure deployment should be evident, and the ACCC will accordingly be better able to assess the appropriateness of continued declaration.

The ACCC also considers that this period would be consistent with the ACCC's position in its Strategic review of fixed network services, where it has decided to continue declaration of the ULLS and PSTN originating and terminating access services for three years.[1] A three year declaration period for the LCS would allow the ACCC to synchronise the declaration reviews of these related fixed network services.

Geographic exceptions to declaration

In recognition of the previous exemption granted to the LCS in the CBD areas of Sydney, Melbourne, Adelaide, Brisbane and Perth, the ACCC considers that the continued declaration of LCS and declaration of WLR should not apply in those CBD areas.

Telstra submitted to the review that there was significant competitive infrastructure present in many other exchange areas and that further geographic areas should be exempt from declaration.

The ACCC has previously excluded certain geographic routes from transmission capacity regulation, based on the existence of competing transmission facilities. However, the ACCC considers that it would be inappropriate and problematic to do this in the context of the LCS and WLR declarations. Unlike transmission services, the nature of any exclusion would be far less discrete and clear cut, given the patchwork of differing network footprints that exist or are in prospect.

Accordingly the ACCC considers that the declaration should apply to all geographic areas except for the five identified CBD areas. However the ACCC notes the availability of a formal ex post process available through the granting of exemptions from the Standard Access Obligations. This would allow applicants to seek exemptions from regulation for particular regions. The ACCC also notes the possibility of an audit of competitive infrastructure as discussed in its Strategic review of fixed network services. Such an audit may inform exemption applications and the exclusion of particular geographic areas at the time of the next declaration review.

---

1 ACCC, *Declaration inquiry for the ULLS, PSTN OTA and CLLS—final determination*, July 2006.

Pricing principles and draft indicative prices

The extent to which continued declaration will promote competition is likely to depend on the prices paid by access seekers for the declared services. The ACCC has made a pricing principle determination, in accordance with section 152AQA of the TPA, that an interim retail-minus-retail-cost approach should be used to price the LCS and WLR services. The ACCC will be developing a robust cost model that produces appropriate estimates of cost in all geographic areas. Once such a model is complete, the ACCC will seek to implement a cost-based pricing approach for the two services.

The ACCC has also provided draft indicative prices that might apply to the WLR service and the LCS under the interim retail-minus-retail-cost pricing approach. The ACCC is seeking comment on these indicative prices by **31 August 2006**.

Any written submissions on the indicative prices should be provided to:

Michael Eady

Australian Competition and Consumer Commission

GPO Box 520

MELBOURNE VIC 3000

Phone: 03 9290 1945

Fax: 03 9663 3699

Email: michael.eady@accc.gov.au

Any questions about submissions on the indicative prices can be directed to Michael Eady by phone or email. Parties should note that any submissions should be confined to the discussion of indicative prices in section 10.8 of this report. The ACCC is not seeking further comment on its final decisions on declaration of the services, applicable pricing principle or implementation issues.

The ACCC will issue a final decision on the indicative prices once any submissions received are considered.

2 Introduction

On 22 April 2005, the Australian Competition and Consumer Commission (ACCC) commenced a public inquiry to review the local carriage service (LCS) declaration. The review, which was required under the *Trade Practices Act 1974* (TPA), was to determine under section 152ALA, having regard to the long-term interests of end users (LTIE), whether to:

- extend or further extend the expiry date of the declaration
- revoke the declaration
- vary the declaration
- allow the declaration to expire without making a new declaration under section 152AL, or
- allow the declaration to expire and then to make a new declaration under section 152AL.

The ACCC received six submissions in response to the discussion paper. In March 2006, the ACCC released the draft decision and received another three submissions. A list of all the written submissions received can be found at Appendix A.

2.1 The local carriage service

The LCS is used by service providers to supply local calls to end-users. It allows competitive entrants to resell local calls without deploying substantial alternative infrastructure.

As set out in the former service description reproduced in Appendix B, the LCS is the supply of an end-to-end voice grade carriage service between two points within a standard zone.[2] The access provider is responsible for the carriage of the call between the calling party and called party. Access seekers then resell this service to end-users. Vertical elements which can be self-supplied, or competitively sourced, by the service provider are not included. In re-supplying the LCS to the end-user the service provider may seek to 'value add' or simply resell.

2.2 Structure of this report

This report sets out the information, analysis and reasons upon which the ACCC's decision has been made. The report is structured as follows:

- **Section 3** briefly outlines the access regime and relevant provisions governing the declaration process.

---

[2] The term 'standard zone' is defined in Part 4 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999.*

- **Section 4** outlines the principles for developing service descriptions.
- **Section 5** outlines the role and purpose of regulatory intervention and the relationship between resale and facilities-based competition.
- **Section 6** identifies the markets that are the focus of the inquiry.
- **Section 7** outlines the test for declaration of the LCS.
- **Section 8** outlines the test for declaration of the line rental service.
- **Section 9** discusses issues raised by interested parties concerning the service descriptions for the two services.
- **Section 10** outlines the pricing principles for the declared services.

Appendix A provides a list of submissions received.

Appendix B provides the former service description of the LCS.

Appendix C provides the new service description of the LCS.

Appendix D provides the new service description of the line rental service.

3 Legislative background

3.1 The access regime

Part XIC of the TPA sets out a telecommunications access regime. The ACCC may determine that particular carriage services and related services are declared services. Once a service is declared, carriage service providers (CSPs) are required to comply with standard access obligations (SAOs) in relation to supply of the declared service. The SAOs facilitate the provision of access to declared services by service providers in order that service providers can provide carriage services and/or content services. In addition to its SAOs, a carrier, CSP or related body must not prevent or hinder access to a declared service.

3.2 Maintaining, varying or revoking an existing declaration

Section 152ALA of the TPA requires the ACCC to review each declaration within the year preceding its expiry date.

The purpose of the review, as set out in section 152ALA(7) of the TPA, is to determine

- whether the expiry date for the declaration should be extended or further extended,
- whether the declaration should be varied or revoked,
- whether the declaration should be allowed to expire and, if so, whether a new declaration should be made.

An extension to an expiry date, or the expiry date for a new declaration, may not be for more than five years.

Section 152ALA of the TPA states that the ACCC must:

- hold a public inquiry in accordance with Part 25 of the Telecommunications Act 1997 on whether to extend the expiry date for the declaration, vary or revoke the declaration, or allow the declaration to expire (with or without a new declaration being made)
- prepare and publish a report setting out the ACCC’s findings.

The ACCC’s powers to extend the expiry date for a declaration, vary or revoke a declaration, or allow a declaration to expire (with or without a new declaration being made), are set out in sections 152AL, 152ALA and 152AO of the TPA. In exercising these powers, the ACCC is required to consider the effect on the LTIE of carriage services and services provided by means of carriage services.

3.3 The ACCC's approach to the LTIE

The ACCC must decide whether declaring the service would promote the LTIE of carriage services, or of services supplied using carriage services (listed services).

Section 152AB of the TPA provides that, in determining whether declaration promotes the LTIE, regard must be had only to the extent to which declaration is likely to result in the achievement of the following objectives.

- promoting competition in markets for listed 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 or are, or are likely to become, capable of being supplied.

Section 152AB also provides further guidance in interpreting these objectives.

The three objectives are discussed below.

3.3.1 Promoting competition

Subsections 152AB(4) and (5) provide that, in interpreting this objective, regard must be had to, but is not limited to, the extent to which the arrangements will remove obstacles to end-users gaining access to listed services. The Explanatory Memorandum to Part XIC of the TPA states that:

> ...it is intended that particular regard be had to the extent to which the...[declaration]... would enable end-users to gain access to an increased range or choice of services. [3]

This criterion requires the ACCC to make an assessment of whether or not declaration would be likely to promote competition in the markets for listed services.

The concept of competition is of fundamental importance to the TPA and has been discussed many times in connection with the operation of Part IIIA, Part IV, Part XIB and Part XIC of the TPA.

In general terms, competition is the process of rivalry between firms, where each market participant is constrained in its price and output decisions by the activity of other market participants. The Trade Practices Tribunal (now the Australian Competition Tribunal) stated that:

> In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.

[3] Trade Practices Amendment (Telecommunications) Act 1997 (Cth) Explanatory Memorandum.

> Competition is a process rather than a situation. Nevertheless, whether firms compete is very much a matter of the structure of the markets in which they operate.[4]

Competition can provide benefits to end-users including lower prices, better quality and a better range of services over time. Competition may be inhibited where the structure of the market gives rise to market power. Market power is the ability of a firm or firms profitably to constrain or manipulate the supply of products from the levels and quality that would be observed in a competitive market for a significant period of time.

The establishment of a right for third parties to negotiate access to certain services on reasonable terms and conditions can operate to constrain the use of market power that could be derived from the control of these services. Accordingly, an access regime such as Part IIIA or Part XIC addresses the *structure* of a market, to limit or reduce the sources of market power and consequent anti-competitive conduct, rather than directly regulating conduct which may flow from its use, which is the role of Part IV and Part XIB of the TPA. Nonetheless, in any given challenge to competition, both Parts XIB (or IV) and XIC may be necessary to address anti-competitive behaviour.

To assist in determining the impact of potential declaration on downstream markets, the ACCC will first need to identify the relevant market(s) and assess the likely effect of declaration on competition in each market.

Section 4E of the TPA provides that the term 'market' includes a market for the goods or services under consideration and any other goods or services that are substitutable for, or otherwise competitive with, those goods or services. The ACCC's approach to market definition is discussed in its *Merger Guidelines,* June 1999 and in *Anti-competitive conduct in telecommunications markets,* August 1999.

The second step is to assess the likely effect of declaration on competition in each relevant market. As noted above, subsection 152AB(4) requires that regard must be had to the extent to which declaration will remove obstacles to end-users gaining access to listed services.

The ACCC considers that denial to service providers of access to necessary upstream services on reasonable terms is a significant obstacle to end users gaining access to services. Declaration can remove such obstacles by facilitating entry by service providers, thereby providing end users with additional services from which to choose. For example, access to a mobile termination service may enable more service providers to provide fixed to mobile calls to end-users. This gives end-users more choice of service providers.

Where existing market conditions already provide for the competitive supply of services, the access regime should not impose regulated access.[5] This recognises the costs of providing access, such as administration and compliance, as well as potential disincentives to investment. Regulation will only be desirable where it leads to benefits

---

4 Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Ltd (1976) ATPR 40-012, 17,245.

5 Trade Practices Amendment (Telecommunications) Act 1997 (Cth) Explanatory Memorandum.

in terms of lower prices, better services or improved service quality for end-users that outweigh any costs of regulation.

In considering whether declaration will promote competition, it is therefore appropriate to examine the impact of the proposed service description on each relevant market, and compare the state of competition in that market with and without declaration. In examining the market structure, the ACCC considers that competition is promoted when market structures are altered such that the exercise of market power becomes more difficult. Examples would include where barriers to entry have been lowered (permitting more efficient competitors to enter a market and thereby constrain the pricing behaviour of the incumbents) or where the ability of firms to raise rivals' costs is restricted.[6]

3.3.2 Any-to-any connectivity

Subsection 152AB(8) provides that the objective of any-to-any connectivity is achieved if, and only if, each end-user who is supplied with a carriage service that involves communication between end-users is able to communicate, by means of that service, or a similar service, with other end-users whether or not they are connected to the same network. The reference to 'similar' services in the TPA enables this objective to apply to services with analogous, but not identical, functional characteristics, such as fixed and mobile voice telephony services or Internet services which may have differing characteristics.

The any-to-any connectivity requirement is particularly relevant when considering services that involve communications between end-users.[7] When considering other types of services (such as carriage services that are inputs to an end-to-end service or distribution services such as the carriage of pay television), the ACCC considers that this criterion will be given less weight compared to the other two criteria.

3.3.3 Efficient use of, and investment in, infrastructure

Subsections 152AB(6) provide that, in interpreting this objective, regard must be had to, but not limited to, the following:

- whether it is technically feasible for the services to be supplied and charged for, having regard to:
    - the technology that is in use or available
    - whether the costs that would be involved in supplying, and charging for, the services are reasonable
    - the effects, or likely effects, that supplying, and charging for, the services would have on the operation or performance of telecommunications networks

---

[6] See also *Re Sydney International Airport* [2000] ACompT 1 at paragraph 106 for discussion on when competition is promoted.

[7] Trade Practices (Telecommunications) Amendment Act 1997 (Cth) Explanatory Memorandum.

- the legitimate commercial interests of the supplier or suppliers of the service, including the ability of the supplier or suppliers to exploit economies of scale and scope

- the incentives for investment in:

  - the infrastructure by which the services are supplied

  - any other infrastructure by which the services are, or are likely to become, capable of being supplied.

In considering the incentives for investment, ss. 152AB(7) provides that the ACCC must have regard to the risks involved in making the investment.

The matters in s. 152AB(6) are interrelated. In many cases, the LTIE may be promoted through the achievement of two or all of these criteria simultaneously. In other cases, the achievement of one of these criteria may involve some trade-off with another of the criteria, and the ACCC will need to weigh up the different effects to determine whether declaration promotes the LTIE. In doing so, the ACCC will interpret long-term to mean the period of time necessary for the substantive effects of declaration to unfold.

Economic efficiency has three components.

- *Productive efficiency* refers to the efficient use of resources within each firm such that all goods and services are produced using the least cost combination of inputs.

- *Allocative efficiency* refers to the efficient allocation of resources across the economy such that the goods and services that are produced in the economy are the ones most valued by consumers. It also refers to the distribution of production costs amongst firms within an industry to minimise industry-wide costs.

- *Dynamic efficiency* refers to the efficient deployment of resources between present and future uses such that the welfare of society is maximised over time. Dynamic efficiency incorporates efficiencies flowing from innovation leading to the development of new services, or improvements in production techniques.

The ACCC will need to ensure that the access regime does not discourage investment in networks or network elements where such investment is efficient. The access regime also plays an important role in ensuring that existing infrastructure is used efficiently where it is inefficient to duplicate investment in existing networks or network elements.

3.3.4 The technical feasibility of supplying and charging for particular services

This incorporates a number of elements, including the technology that is in use or available, the costs of supplying, and charging for, the services and the effects on the operation of telecommunications networks.

The technical feasibility of supplying and charging for particular services given the current state of technology may often be clear, particularly where there is a history of providing access. The question will be more difficult where there is no prior access or where conditions have changed. Experience in other jurisdictions, taking account of relevant differences in technology or network configuration, will be helpful. Generally the ACCC will look to an access provider to demonstrate that supply is not technically feasible.

3.3.5 The legitimate commercial interests of the supplier or suppliers, including the ability of the supplier to exploit economies of scale and scope

A supplier's legitimate commercial interests encompass its obligations to the owners of the firm, including the need to recover the cost of providing services and to earn a normal commercial return on the investment in infrastructure. The ACCC considers that allowing for a normal commercial return on investment will provide an appropriate incentive for the access provider to maintain, improve and invest in the efficient provision of the service.

A significant issue relates to whether or not capacity should be made available to an access seeker. Where there is spare capacity within the network, not assigned to current or planned services, allocative efficiency would be promoted by obliging the owner to release capacity for competitors.

Paragraph 152AB(6)(b) also requires the ACCC to have regard to whether the access arrangement may affect the owner's ability to realise economies of scale or scope. Economies of scale arise from a production process in which the average (or per unit) cost of production decreases as the firm's output increases. Economies of scope arise from a production process in which it is less costly in total for one firm to produce two (or more) products than it is for two (or more) firms to each separately produce each of the products.

Potential effects from access on economies of scope are likely to be greater than on economies of scale. A limit in the capacity available to the owner may constrain the number of services that the owner is able to provide using the infrastructure and thus prevent economies of scope associated with the production of multiple services. In contrast, economies of scale may simply result from the use of the capacity of the network and be able to be realised regardless of whether that capacity is being used by the owner or by other carriers and service providers. Nonetheless, the ACCC will assess the effects of the supplier's ability to exploit both economies of scale and scope on a case-by-case basis.

3.3.6 The impact on incentives for investment in infrastructure

Firms should have the incentive to invest efficiently in infrastructure. The concept of efficiency has been discussed above. It is also important to note that while access regulation may potentially diminish incentives for some businesses to invest in infrastructure, it also ensures that investment is efficient and reduces barriers to entry for other (competing) businesses or barriers to expansion by competing businesses.

There is also a need to consider the effects of any expected disincentive to investment from anticipated increases in competition to determine the overall effect of declaration on the LTIE. The ACCC will be careful to ensure that services are not declared where there is a risk that incentives to invest may be dampened, such that there is little subsequent benefit to end-users from the access arrangements.

4 Service description

A fundamental step in determining whether a given service should be declared is to establish how the service in question should be described. This gives interested parties a basis from which to discuss whether the service should be declared, and gives parties a firm idea of the service that access providers would be required to supply were the service to be declared. It also assists the ACCC by giving it a field within which it can meaningfully analyse whether declaration of the service, so defined, would promote the LTIE.

As the note to sub-section 152AL(3) states:

> Eligible services may be specified by name, by inclusion in a specified class or in any other way.[8]

The Explanatory Memorandum for the *Trade Practices Amendment (Telecommunications) Bill 1996* adds:

> In making a declaration of an eligible service, the ACCC will have a high level of flexibility to describe the service, whether it be in functional or any other terms. This will enable, where appropriate, the ACCC to target the access obligations (which are triggered by a declaration) to specific areas of bottleneck market power by describing the service in some detail, or to more broadly describe a service which is generally important (such as services necessary for any-to-any connectivity).[9]

4.1 Principles for developing a service description

When developing the description of an eligible service, the ACCC is guided by the object of Part XIC of the TPA, which is to promote the LTIE.

In most cases, some degree of technical specification is required. However, the ACCC's preference is to describe the service in terms which are as functional as possible. In such a situation, the declaration will leave the access provider with flexibility to determine the most efficient way of supplying the service. This also provides more flexibility to the access seeker in the type of service that can be provided within the ambit of the declared service and avoids distorting technological or innovative developments. Technical terms may, however, be appropriate where a functional description would provide scope for ambiguity which could be exploited by the access provider in a manner that hinders access.

The eligible service should be described in a manner which provides sufficient clarity for application of the SAOs.

---

8 See Acts Interpretation Act 1901 (Cth) s. 46(2).

9 Trade Practices (Telecommunications) Amendment Bill (1996) Explanatory Memorandum, item 6, proposed s. 152AL.

The service should be one for which it is technically feasible to supply and charge. In addition, the service should be one that a potential access provider is supplying to itself or others.

The ACCC further discusses the service descriptions for the LCS and WLR services in section 9.

5 Role and purpose of regulatory intervention

The purpose of the local services review is twofold:

1 to determine whether the LCS declaration continues to be in the LTIE and, if so, what form ongoing regulation of the LCS should take, and also to consider whether a WLR service should be declared

2 to consider a range of local call service issues and determine whether local services regulation can be more appropriately structured to encourage competition and promote efficiency in a range of telecommunication markets.

The ACCC's consideration of declaration of the LCS and WLR is in the LTIE is contained in subsequent sections. This section considers the second purpose for the review – more general issues about the regulation of LCS and the impact of local call service regulation on competition and efficiency in the telecommunications market.

A central issue in this broader discussion is the relationship between resale and facilities-based competition. It should be noted that a number of submissions to the Discussion Paper argued forcefully against what they see as the ACCC's bias against resale or service based competition.

Other submissions, Telstra's in particular, responded to the theme in the Discussion Paper about regulatory options, specifically the use of Part XIB as well as other powers in promoting efficient competitive outcomes.

5.1 Relationship between resale and facilities-based competition

5.1.1 Issues raised by the discussion paper

When declaring the LCS in 1999, the ACCC believed that the LCS would provide a stepping stone towards facilities-based competition. The ACCC has frequently made clear what it sees as the advantage of facilities/infrastructure based competition:

> The expansion of infrastructure has brought significant benefits to consumers. There has been a general downward trend in the prices of most call services with the price of an average basket of telecommunications services falling by 20.1 per cent in real terms between 1997–98 and 2002–03. And in the year since the ACCC intervened in the ADSL pricing case, broadband take-up has exceeded 1 million – a massive 120 per cent increase in just 12 months.
>
> Importantly, the explosion in broadband customers has been shared by both Telstra and its wholesale competitors.
>
> Broadband take up has now reached the point where it is becoming increasingly viable for access seekers to roll-out their own DSL infrastructure into a larger number of Telstra's exchanges.
>
> These outcomes highlight the benefits that are possible through infrastructure-based competition. Whereas the initial benefits of the current telecommunications regulatory regime were almost entirely due to competitors entering at the retail level and making use of regulated

> interconnection to drive down retail costs, the more competitive, innovative areas are those in which competitors have built their own networks, rather than just reselling space on Telstra lines.[10]

Recently, it has been observed that facilities-based competition, particularly through predicted take-up of the ULLS, is likely to develop over the coming years. Telstra has predicted that take-up of the ULLS will reach 1.8 million lines within three years.[11] Several competitors to Telstra have begun to invest in ULLS-enabling technology, while others have announced and/or are in the process of commencing their roll-outs. iiNet stated in January 2006 that it had 186 DSLAMs installed in exchanges, with almost 75,000 customers on ULLS.[12] It also announced in March 2006 that by January 2007 it would have DSLAMs in more than 350 exchanges and coverage extending to more than 4 million households.[13] Primus has also commenced a DSLAM deployment, with over 130 DSLAMs installed and more than 40,000 customers on ULLs.[14] Optus announced in September 2005 that it plans to roll-out DSLAMs to a sufficient number of exchanges to enable it to engage in facilities-based competition for 2.9 million end-users.[15]

The LCS may or may not have provided an effective stepping stone towards these developments. Competitive entrants are not able to break-even by reselling bundled local calls and line rental. Nevertheless, competitors are active in the retail voice market. These competitors do use the LCS as part of their retail market offerings. Further, some of these retail market competitors are those who have announced and/or are rolling out ULLS enabling investments.

However, it has been argued that the LCS service may deter movement towards a facilities-based approach where it dampens incentives for adopting a ULLS-based strategy. Given this, 'whether the LCS remains a complement to a facilities–based approach or whether it has become a substitute or disincentive to infrastructure' remains a relevant question in certain circumstances.[16]

---

[10] Ed Willettt, Commissioner, speaking at the AFR Fourth National Infrastructure Summit, Sydney, August 2005. The speech is available from the ACCC website,www.accc.gov.au

[11] Kate McKenzie, *Senate Estimates - Environment, Communications, Information Technology and the Arts Committee*, 31 October 2005, p. ECITA 123. Telstra's estimate was dependent on a range of assumptions regarding price and non-price factors, which were not fully disclosed.

[12] iiNet, *January iiNews*, available at http://www.iinet.com.au/news/news_0106.html.

[13] iiNet, *March iiNews*, available at http://www.iinet.com.au/about/news/news_0306.html

[14] G. Lynch, *Primus says it will beat 2005 DSL target, as on-net gross margins surge to 50%*, Communications Day, Iss 2662, 3 November 2005, p. 1.

[15] Optus, *Optus steps up competition with DSLAM rollout*, 22 September 2005, http://home.singtel.com/news_centre/news_releases/2005_09_22.asp.

[16] ACCC, *Local Services Review 2005*, Discussion Paper. April 2005, p. 3.

Alternatively, the growth of broadband, the impact of alternative networks/technologies and arrival of VoIP may provide an alternative path towards facilities-based competition.

Some submissions question the relationship between service and facilities-based competition from a different perspective, posing the question as to whether service competition should be seen as an end goal in its own right and should not be assessed only in terms of its ability to stimulate facilitates-based competition.

5.1.2 Submissions from interested parties

AAPT

Firstly, AAPT states that:

> Recent documents by the ACCC and the Discussion Paper in particular have expressed a bias towards the development of what is called 'facilities-based competition'.[17]

AAPT contends that this 'bias' is inconsistent with the objectives of the TPA because it misrepresents the historical context of deregulation of the industry, and promotes inefficient investment.[18]

Secondly, AAPT suggests that the LCS declaration has played an important role in promoting competition in the long distance telephony market:

> While some of the competition in international markets is now being led by the calling card industry, the role of the LCS in promoting competition in the long distance market must not be understated.[19]

AAPT believes that this role is reason enough to continue the LCS declaration.

Third, AAPT suggests that the definable local telephony market exists only as a consequence of regulatory decisions, and:

> …has no inherent distinction in the production technology underpinning it, nor in any customer demand characteristics other than that imposed by regulation.[20]

Australian Communications Network (ACN)

ACN states that:

> ACN has consciously and consistently chosen to be a non-infrastructure based provider in all markets in which it operates so that it can focus its efforts on those elements of the supply of

---

17 AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 3.

18 ibid.

19 ibid., p. 8.

20 ibid., p. 9.

> communications services where it has a competitive advantage – customer acquisition & marketing, service provisioning, billing & payment and customer care.[21]

ACN believes that the LCS in combination with competitive long distance and other services has provided consumers with enhanced benefit and choice, although this is beginning to falter.

ACN argues that:

- the only realistic competitive alternatives to LCS are not true facilities-based competition but merely other types of access-based competition

- in the local/access context (at least outside CBDs), access-based competition actually promotes the LTIE to a greater extent than facilities-based competition.[22]

ACN also states:

> The LTIE are maximised by a situation in which infrastructure services are provided by the most efficient provider of that element – the natural monopolist, while non-infrastructure services are provided by the most efficient providers of those elements – resellers of the LCS such as ACN.[23]

Competitive Carriers' Coalition Inc (CCC)

The CCC submits that a range of competitive entry models may be legitimately used, stating that:

> …some competitors might not wish to invest beyond what is necessary to establish a pure reseller business. As long as there is the opportunity for others to invest further, the CCC does not believe this should be discouraged.[24]

The CCC also states:

> If a competitor can establish a position in the market as a pure reseller, they should be free to do so, and it should be acknowledged that this adds a useful element of competitive tension to a market, especially where facilities based competition is nascent.[25]

The CCC reiterated its position in its submission in response to the draft decision, stating that it considered that "the aim should not be facility based competition at any cost".[26]

---

[21] Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 1.

[22] ibid., p. 2.

[23] Ibid, p. 5.

[24] Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 3.

[25] ibid.

[26] CCC, *Local services review draft decision March 2006—Competiive Carrier's Coalition (CCC) submission*, April 2006, p. 2.

Optus

Optus signals its commitment to facilities-based competition, stating that:

> Facilities based competition provides for competitive pressures across a wider cost base than resale competition. It also allows for deeper product differentiation and greater innovation than resale competition.[27]

However, Optus also states:

> Where facilities based competition is not feasible, regulation may be warranted… A form of resale based regulation may also be required where infrastructure competition is uneconomic.[28]

Southern Phone Company (SPC)

SPC argues that a reseller role is the only possible option in some regional areas of Australia, stating:

> …there is no alternative technology currently available that can work economically, effectively and broadly in regional Australia. The problem remains that a small, widely dispersed market prevents the development of a satisfactory business case that relies on economies of scale to justify investment.[29]

Telstra

Telstra states:

> …a decision by the Commission not to extend the LCS declaration will promote competition by giving service providers the appropriate incentives to use and extend alternative infrastructure, and will also promote competition in the upstream local services market by encouraging other carriers to offer wholesale local services.[30]

Telstra stated in its submission in response to the draft decision that there was a "lack of evidence in support of the stepping-stone model" and that "the stepping-stone model has proven to be a failure and is being wound back throughout the world".[31]

5.1.3 ACCC's view

The ACCC has on a number of occasions put forward the view that effective competition involves facilities-based competition. Without some level of independent infrastructure, it is difficult to see how the conditions of effective competition such as independent rivalry in the price/product/service package can be achieved. However, it is difficult to form clear conclusions on the basis of the available evidence and

---

27 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 3.

28 ibid.

29 Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 3.

30 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 3.

31 Telstra, *Telstra's submission in response to the Local services review*, April 2006, p. 8.

argument as to whether declaration of the LCS has provided a stepping stone to facilities-based competition.

As noted above, there are a number of competitors active in the retail voice market, and several of these competitors have announced and commenced ULLS-based investment. Accordingly, the ACCC is of the view that it is likely that the LCS has improved the incentives for such deployments. While the exact magnitude of its impact remains difficult to determine, the ACCC continues to believe that the LCS continues to serve as an effective complement to facilities-based deployments by access seekers, and therefore to effective and sustainable longer-term competition.

Submissions have clearly stated that resale also plays an important role in providing ongoing retail competition in regions where facilities-based competition is unlikely to be economic. In such circumstances retail competition can drive cost efficiencies and encourage innovation at the retail level by providing a level of competitive tension in the market which would otherwise remain absent.

The ACCC considers that the original justifications with respect to the stepping stone approach remain valid, and that ongoing facilities-based developments are likely to continue to be complemented by the continued declaration of the LCS. Further, the ACCC also agrees with submitters that the LCS is likely to have an ongoing role in providing an important level of competitive tension in the market in all regions where facilities-based competition is not likely to be economic.

6 Defining relevant markets

6.1 The ACCC's approach

As indicated in Section 3, section 152AB of the TPA provides that, in determining whether declaration promotes the LTIE, regard must be had only to the extent to which declaration is likely to result in the achievement of the following objectives:

- promoting competition in markets for listed 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.

Accordingly, to examine whether declaration would be likely to promote competition, the ACCC may consider both:

- the market in which the eligible service is or would be supplied
- the market or markets in which competition may be promoted (where these are separate markets).

When determining whether declaration is likely to promote competition in telecommunications markets, it is important for the ACCC to first understand the existing state of competition in the market within which the eligible service is provided and all other related markets. To make this assessment, it is necessary to assess the boundaries of the markets in which the eligible service and other related services are supplied.

Once the boundaries of the relevant markets have been identified, the ACCC can then consider whether the state of competition in these markets will be enhanced by declaration of the eligible service. Where appropriate and where the ACCC considers it facilitates its consideration of the matters in section 152AH(1), the ACCC uses the 'future with and without' test from the Sydney Airports case[32] as an aid. Under this approach, the ACCC considers whether competition in identified markets would be likely to be further promoted with declaration as opposed to a structure where the service was not declared. Only by understanding market dynamics and the current state of competition in these markets can the likely future state of competition be meaningfully assessed.

In assessing whether the declaration of an eligible service is likely to promote competition, therefore, the ACCC undertakes the following analysis:

---

32 *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

- First, it identifies those markets relevant to determining whether declaration will promote competition.

- Secondly, it assessed the current state of competition and the dynamics that operate within these markets. If the current state of competition in any of these markets is found to be less than effective, an assessment is made regarding the extent to which competition would be promoted, or be likely to be promoted, in the future by declaration of the eligible service.

In this inquiry, the ACCC is considering the declaration of two eligible services, the WLR service and the LCS. This section deals with establishing the market(s) in which the eligible services and related services are provided. The subsequent competition analysis is in sections 7 and 8 of the report.

6.2 Market definition

6.2.1 The ACCC's approach to defining relevant markets

In any declaration review, the identification of the relevant market is necessary as it provides the ACCC with a starting point from which to analyse the extent of competition in a given market and the possible need for regulation.

The market definition process begins by identifying the service under consideration and the firm(s) supplying that service.

In having regard to the markets which may be affected, the ACCC gives consideration to the markets in which the services are supplied as well as vertically-related markets. In telecommunications, the relevant market affected by declaration could be upstream, downstream or at the same level.

Market boundaries incorporate all sources and potential sources of close substitution with which the firm supplying the service would compete. Section 4E of the TPA states:

> … 'markets' means a market in Australia and, when used in relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first mentioned goods or services.

As noted by the High Court:

> This process of defining a market by substitution involves both including products which compete with the defendant's and excluding those which because of differentiated characteristics do not compete.[33]

To identify services that are 'substitutable for, or otherwise competitive with' the services under consideration, the ACCC uses the "price elevation test". This test is premised on the idea that the availability of close substitutes (on both demand and supply sides) constrains the ability of suppliers to profitably divert prices or the quality

33 Queensland Wire Industries Pty Ltd. BHP Ltd (1989) ATPR 4—925, p. 50,008 per Mason CJ and Wilson J.

of services from competitive levels. The resulting market is the smallest area over which a hypothetical profit maximising monopolist could impose a small but significant and non-transitory price increase (SSNIP).

Where an industry has traditionally been a vertically integrated government monopoly unresponsive to the relative efficiency of such structures, the ACCC must also consider the likely evolution of vertical relations and the scope for market transactions at various vertical stages.[34]

In addition, the ACCC must take account of 'commercial reality' to ensure that the markets which it defines accurately reflect the arena of competition. Specific industry characteristics must be considered. For example, it is argued that in the case of telecommunications the SSNIP test needs to take into account:[35]

- The extent of supply substitutability, incorporating the forward-looking extent of substitutability by different and/or emerging technologies.

- Significant complementarities in demand as well as scope economies in supply. Services may be supplied and demanded in a bundled form. With regard to demand, there are some circumstances where no independent demand for particular services (such as access) exists.

- The nature of competition in the industry where service performance and innovation is more relevant than price as a source of competition. In such cases concentration on cross-price elasticities may misrepresent the boundaries of a market.

These are all critical issues which must be considered.

In identifying relevant markets, Part XIC of the TPA does not require the ACCC to take a definitive or determinative stance on market definition as may be the case in a Part IV or Part XIB case.[36] The Federal Court also endorsed this approach in its decision to uphold the validity of certain broadcasting access declarations by the ACCC.[37]

Furthermore, over time, declaration itself might affect the dimensions of these markets, particularly in relation to the functional dimension. Accordingly, market analysis under Part XIC should be seen in the context of providing an analytical framework to examine how declaration would promote competition rather than in the context of developing 'all purpose' market definitions.

---

34 See paragraph 5.66 of the ACCC's *Merger guidelines*, June 1999.

35 Gual J, *Market Definition in the Telecoms Industry*, 2002, prepared for the European Commission (DGCOMP) under contract: COMP/2001/7050/PSE/02, p 47.

36 ACCC, *Telecommunications services – Declaration provisions*, July 1999.

37 Foxtel Management Pty Ltd v Australian Competition & Consumer Commission [2000] FCA 589.

The ACCC considers that market definition can be relevantly assessed by reference to four market dimensions:

- product
- functional
- geographic
- time.

6.2.2 ACCC's draft decision

The ACCC conducted an extensive assessment of the relevant market definitions in its draft decision.[38] The conclusions are summarised below.

6.2.2.1 Wholesale markets

The ACCC made the following conclusions on WLR and wholesale local calls:

- There appears to be little reason why the provision of WLR should continue to be tied to a specific voice service. Line rental is an essential input into the provision of both voice and data services and tying it to one specific voice service would appear to inhibit access seeker's ability to compete with Telstra. Unbundling WLR from LCS would not appear entail any particular efficiency losses.

- At the current time, there are no widespread effective substitute products for Telstra's WLR service, nor for the provision of the wholesale supply of local call services by Telstra to carriers and carrier service providers.

- Line rental should be seen as a separate stage of the supply chain to the supply of the local call, and they should be regarded as separate functional markets.

- It is appropriate to recognise the ACCC's previous conclusion that, in the CBD areas of Sydney, Melbourne, Brisbane, Adelaide and Perth, there is sufficient alternative local access infrastructure and declared services, such as the ULLS, to provide a constraint on Telstra's prices for WLR and the LCS.[39] At this stage there is no other basis to 'carve out' other geographic areas as having sufficient competition. Accordingly the relevant markets should be seen as national markets but excluding the five CBD areas.

- There is considerable uncertainty about the development of competitive infrastructure platforms and services, such as wireless access, fixed-to-mobile substitution, VoIP and the ULLS, to the WLR service and the LCS. It could be expected that much of this uncertainty might be resolved in two years and that

---

38 ACCC, *Local services review—draft decision*, March 2006, p. 29.

39 ACCC, *Future scope of the Local Carriage Service—final decision*, July 2002.

the effectiveness of these alternatives in constraining Telstra’s decisions regarding LCS and WLR would be more evident at that time.

Accordingly the ACCC concluded that there were two relevant wholesale markets:

- the national WLR market, with the exemption of the CBD areas of Adelaide, Brisbane, Melbourne, Perth and Sydney

- the national market for providing local calls to other carriers and carriage service providers via the LCS or other means in the national market, with the exemption of the CBD areas of Adelaide, Brisbane, Melbourne, Perth and Sydney.

6.2.2.2 Retail markets

The ACCC concluded in its draft decision that the relevant downstream markets at their narrowest could be defined as separate retail markets for line rental and local calls, or more widely as a market for retail fixed voice services which necessarily includes both retail line rental and local call services. The ACCC did not consider that it was necessary to form a precise view as to the boundaries of the downstream retail voice market.

6.2.3 ACCC’s final view

The ACCC considers that the analysis presented in the ACCC’s draft decision is a thorough assessment of the relevant market definitions for the purpose of this declaration review. It notes that there were no submissions from interested parties that disputed the assessment.

Telstra did submit that ‘it is not at all clear from the market definition section of the Commission’s paper, what the Commission’s product market definition is supposed to be’.[40] The ACCC notes that it did not provide a precise view as to the boundaries of the downstream retail voice market. However it again reiterates that Part XIC of the TPA does not require the ACCC to take a definitive or determinative stance on market definition as may be the case in a Part IV or Part XIB of the TPA.[41] The ACCC does not consider that it needs to form a precise view as to the boundaries of the market as the purpose of market definition in a declaration assessment is to assess whether competition will be promoted.

The ACCC considers that its views on market definition as expressed in the draft decision are appropriate and correct. It does not consider it necessary to repeat the full assessment for the purposes of this final decision.

---

[40] Telstra, *Telstra’s submission in response to the Local Services Review*, April 2006, p. 31.

[41] ACCC, *Telecommunications services—Declaration provisions,* July 1999.

7 Test for declaration – local call

7.1 Would declaration of the LCS continue to be in the LTIE?

Section 152AL of the TPA provides that the ACCC may declare an eligible service if it is satisfied that the making of the declaration will promote the LTIE of carriage services or services provided by means of carriage services. In turn, section 152AB of the TPA provides that, in determining whether declaration promotes the LTIE, regard must be had only to the extent to which declaration is likely to result in the achievement of the following objectives:

- promoting competition in markets for listed 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.

In addition, where appropriate and where the ACCC considers it usefully facilitates its consideration of the matters under section 152AH(1) the ACCC has given consideration to the 'future with and without' test, expressed in the Sydney Airports case.[42] Applying this test requires the ACCC to contrast the outcome assuming the line rental service is declared against the outcome assuming the line rental service is not declared. The ACCC does not apply this test where it considers it does not helpfully assist it with determining the reasonableness of particular terms and conditions. The ACCC notes that while the 'future with and without' test can be applied explicitly, in most instances it is implicit in the ACCC's assessment.

The impact of declaration on each of the three LTIE objectives is addressed below.

7.2 Will declaration promote competition?

The concept of competition is of fundamental importance to the TPA. Competition may be inhibited where the structure of the market gives rise to market power. Market power may be drawn from the ownership of infrastructure required for providing services in the downstream market. Without access to the services provided by infrastructure, a firm would not be able to operate in the downstream market.

The establishment of a right for third parties to negotiate access to certain services, on reasonable terms and conditions, can operate to constrain the use of market power, which could be derived from the control of these services. An access regime such as Part XIC, or Part IIIA of the TPA, attempts to change the structure of a market, to limit or reduce the sources of market power and consequent anti-competitive conduct, rather

---

42 *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

than directly regulating conduct which may flow from market power (which is the role of Part IV and Part XIB of the TPA).

7.2.1 Assessment of competitiveness

In this section the ACCC assesses the level of competition in the market for local call services. This analysis draws upon the market information set out in the previous section and the conclusions drawn by the ACCC in the recent *Telecommunications Competitive Safeguards for 2003-04* report.[43]

7.2.2 Defining competitiveness

While economic theory stresses the importance of perfect competition in providing efficient outcomes, a standard theory of 'effective competition' is more often applied in practice. The ACCC has made an attempt to highlight some of the characteristics of effective competition.[44] Effective competition is likely to be associated with one or more of the following characteristics:

- it is more than the mere threat of competition - it requires competitors to be active in the market, holding a reasonably sustainable market position
- it requires that, over the long run, prices are determined by underlying costs rather than through the exercise of market power
- it requires that barriers to entry are sufficiently low and that the use of market power or collusive behaviour will decline in the long run
- it requires that there be independent rivalry in all dimensions of the price/product/service package and/or
- it does not preclude one party holding a degree of market power from time to time, but that power should pose no significant risk to present and future competition.

While a more detailed discussion of the relationship between access/service competition and facilities-based competition occurs in section 5, here it is worth noting the ACCC's past comment that:

> ..part of the analysis of effective competition must centre on whether there are the appropriate conditions, both competitive and regulatory, to foster dynamic improvements and not just static competition at the current level.[45]

The sustainability of competition must also be assessed. Of particular importance, a market may be said to be sustainably competitive if the benefits that have already accrued would not be lost with the removal of regulation.

---

[43] ACCC, *Telecommunications competitive safeguards for 2003-04*, March 2005.

[44] Ibid., p. 8.

[45] Ibid., p. 9.

Several partial indicators can be used to assess the level of effective and sustainable competition. These indicators include:

- market share and number of competitors
- pricing conduct—significant price decreases are usually an indicator of increased competition although small price increases or decreases can be indicative of a range factors independent of the level of competition in the market
- the existence of barriers to entry such as switching costs, sunk costs and increasing returns to scale.

7.2.3 Characteristics of the LCS market

The critical characteristics of the local call and line rental market were examined in the ACCC's market analysis:

- line rental is a prerequisite for consuming all fixed-line products and also ADSL broadband. Telstra's copper customer access network is essentially a natural monopoly and the source of Telstra's dominance
- while there are three competitive models for local calls the vast majority rely on telephony services provided using Telstra's CAN
- Telstra and Optus are the only full service carriers in all market segments. Other carriage service providers providing local calls and line rental include AAPT, Primus, ACN, Southern Phone Company, SP Telemedia, Macquarie Telecom, etc. The following table shows that while there have been some reductions in Telstra's share of revenue for line rental and local calls from 2001-02, this reduction amounts to a slight adjustment only and the increased revenue share has been taken up by Optus rather than the others in the telecommunications industry. Telstra still has dominance in terms of revenue share. Only 7.2 per cent of line rental revenue and 9.5 per cent of local call revenue was earned by competitors other than Telstra and Optus in 2003-04. Further, these figures are aggregated and therefore include revenue earned in regions of the market currently considered to be competitive and therefore exempt from declaration, and thus are likely to understate Telstra's market shares for the remainder of the national market

Retail revenue share by carrier, 2001-02 to 2003-04

		Telstra	**Optus**	**Other**
Line rental		%	%	%
	2001-02	89.6		10.4
	2002-03	86.8	6.0	7.2
	2003-04	82.1	10.6	7.2

Local calls

2001-02	78.2	10.2	11.5
2002-03	77.0	14.4	8.7
2003-04	75.4	15.0	9.5

Source: ACCC, Telecommunications market indicator report, June 2005, p.11.

- while there is significant retail competition in CBD areas, 99 per cent of the wholesale market is supplied by Telstra **[c-i-c per cent]** and Optus **[c-i-c per cent]**, with Optus' current and potential future supply geographically constrained to areas served by its HFC. In provincial centres, while alternative carriers offer the prospects of alternative sources of supply, Telstra currently provides **[c-i-c per cent]** of connections. In rural and remote areas, Telstra is currently the only carrier that operates in all states and provides local access networks that are not satellite, providing **[c-i-c per cent]** of connections
- the LCS has a range of potential substitutes—take up of the ULL, fixed-to-mobile substitution, use of VoIP. However, as previously noted by the ACCC in its market analysis, it would be difficult to consider that any of these potential substitutes are likely to be effective substitutes for the LCS within the next two years.

7.2.4 Submissions of interested parties

AAPT

AAPT claims that the market for local telephony is not competitive anywhere. AAPT argues that there is a national market for telephony services, but that:

> The existence in one geographic location of competitive infrastructure does not guarantee access to that infrastructure to an alternative service provider.[46]

AAPT suggests that without the ubiquity of coverage that Telstra has, competitors are not able to meet the needs of consumers.

Australian Communications Network Pty Ltd (ACN)

ACN believes that the LCS declaration has not led to a great deal of facilities-based competition, but has provided consumer benefit through increased retail competition. ACN argues that even where carriage service providers progress from LCS to more facilities-based alternatives, in fact:

> The only realistic competitive alternatives to LCS are not true facilities-based competition but merely other types of access-based competition.[47]

[46] AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 12.

Although ACN believes that access-based competition has provided consumer benefit during the period of the LCS declaration, it suggests that this has begun to falter. ACN believes that Telstra has been able to exploit deficiencies in the declaration related to bundling of services and functional equivalence.

Competitive Carriers' Coalition

The CCC stated in its submission in response to the discussion paper that:

> There are no substitutes presently available for LCS. The available alternatives are limited because they rely on access platforms that are themselves limited.[48]

The CCC also submitted that there are no universal substitutes to line rental and as such it is an enduring bottleneck.

In its submission in response to the draft decision, the CCC reiterated its view that ULLS take-up is not likely to constrain Telstra's conduct in the national WLR market and that "as with LCS, there is no competition in the wholesale market for the provision of line rental services".[49]

Optus

Optus does not believe that the LCS has led to a great deal of ULLS-based competition thus far, but considers that recent ULLS price reductions give cause for greater optimism:

> With the improvement of the ULLS business case, we could reasonably expect competition in the local calling services market to emerge, reducing the need for costly LCS access regulation.[50]

Optus further states:

> Optus believes that the provision of local calling services in metropolitan areas could only be removed from regulatory oversight when sufficient competition exists in the wholesale provision of local call resale services (via DSLAM rollout).[51]

Optus believes that the ACCC should determine a threshold level at which regulation in a given band should be rolled back:

---

47 Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 2.

48 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 4.

49 CCC, *Local services review draft decision march 2006—Competitive carriers' coalition (CCC) submission*, April 2006, p. 4.

50 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 5.

51 ibid., p. 7.

> Optus recommends the Commission adopt an 80% target – that is, roll back regulation when 80% of exchanges in metropolitan areas have a competitor's DSLAM installed and in service.[52]

Optus' submission in response to the draft decision largely focused on pricing issues but did submit that "declaration of [the line rental] service has the potential to promote competition in downstream markets".[53]

Southern Phone Company (SPC)

SPC believes that competition in regional areas is not sufficient to roll back regulation:

> …the lack of economies of scale make it extremely unlikely that a competitive infrastructure can be developed in regional Australia to deliver local call services.[54]

Further, SPC states:

> Southern Phone believes any declaration of LCS must recognise the circumstances of regional Australia and allow a continued cross subsidy in service provision between regional and metro areas.[55]

Telstra

Telstra submitted in response to the discussion paper that:

> Telstra believes that there is substantial access-based competition in the downstream fixed telephony services market and the benefits to consumers of this competition will be retained absent the declaration of LCS. A decision by the Commission not to extend its declaration of LCS will, on the other hand, promote competition by giving service providers the appropriate incentives to use and extend alternative infrastructure.[56]

With regard to the upstream market, Telstra also submitted:

> …that the alternative infrastructure and declared services such as ULLS and LSS, provides sufficient competition in the local service market that will be sustained absent LCS declaration.[57]

In its submission responding to the draft decision, Telstra again submitted that there was significant competitive infrastructure present in many areas in Australia and that declaration should only extend to areas where there was not competing infrastructure:[58]

---

52 ibid., p. 8.

53 Optus, *Optus comments on ACCC's draft decision on the Local Carriage Service ("LCS") review*, May 2006, p. 1.

54 Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 4.

55 ibid.

56 Telstra, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 9.

57 ibid., p. 10.

58 Telstra, *Submission in Response to the Local Services Review*, April 2006, p. 8.

> Telstra believes that the Commission must closely examine all competitive infrastructure on an exchange by exchange basis, or on a local calling area basis, together with competitive substitutes, to assess where there is effective competition. Absent this analysis, any declaration is likely to extend to areas where competition is effective, which is not in the LTIE.

Appendix A to Telstra's submission presented further evidence that it submitted demonstrated the extent of the widespread competing infrastructure available. Telstra states that "in most metropolitan areas, competitor infrastructure was accessible to over 70 per cent of Telstra lines".[59] It submitted that this competing infrastructure included alternative fixed networks such as Optus' and TransACT's networks, competitive DSLAM rollouts, mobile networks and wireless networks.

7.2.5 Pricing conduct

Retail price controls have meant that RMRC has been used to ensure neutrality between access seekers and Telstra at the retail level. Access prices are determined using Telstra's unbundled local call price. However, the unbundled local call price is significantly higher than its packaged/bundled offering. For competitors entering the market, bundled plans are the only viable option because it is necessary to provide discounts on either local services or long distance calls as part of a package to offset the competitive disadvantage which may arise from higher prices (in comparison to Telstra) for local services. If a full service bundle is provided by competitors, Telstra imputation tests indicate that there is potentially scope for competitive entry. Even so Telstra can price squeeze its competitors by increasing its unbundled local call prices relative to its bundled local call prices without any corresponding increases in the prices of other services in the bundle.

Price competition in the corporate market has been much more robust and local call prices have declined significantly over the 2002-05 period.[60]

7.2.6 Barriers to entry

Status quo bias can act as a barrier to entry. When combined with actual switching costs (such as contract lock-in) Telstra has considerable advantage as the incumbent provider of telecommunications. Potential competitors have to provide an inducement, such as lower prices, to overcome this bias. This implies that there is less profit to be made as a total service provider than imputation testing is capable of indicating.

Entry into the market may also involve significant risks. To achieve scale economies a firm may need to sell below costs while waiting for market share to push average costs down. This may not be achievable. Sunk costs have also to be considered. To provide the full bundle, contracts would need to be made at minimum with Telstra, Optus, Vodafone, an intra-capital and inter-regional transmission provider and for an international termination service.

---

59 Telstra, *Submission in Response to the Local Services Review*, April 2006, p. 13.

60 ACCC, *Changes in prices paid for telecommunications services in Australia 2004-05*, April 2006, p. 97.

Competitors in this market also have to rely on Telstra to provide services as well as maintenance and churn. In such circumstance economic theory suggests that the incumbent will face a strong incentive to provide lower quality or higher cost services.

The ACCC has concluded that while when assessed individually these barriers may not seem to be insurmountable, taken together they form a significant barrier to entry.

7.2.7 Overall assessment of competition

Other than the market for corporate communications the ACCC is not convinced that the downstream retail voice market is effectively competitive. The market is highly skewed and only Telstra and Optus would appear to be well established in the market. Telstra is the main supplier of wholesale local telephony services, with a market share of around **[c-i-c per cent]**.[61] Service providers re-supplying Telstra's services are the primary source of retail market competition, although as outlined above there is some geographically limited competition from facilities-based operators such as Optus.

On this point, the ACCC notes Telstra's submission that there is significant competitive infrastructure installed in many exchanges throughout Australia and that the ACCC should conduct an "audit of competitive infrastructure". Telstra submitted that this should lead to a "roll-back" of regulation in areas with competitive infrastructure. This view, as noted above, received some support from Optus.[62] Telstra's view mirrors its submissions made to the ACCC's Strategic review of the regulation of fixed network services.

In its June 2006 position paper in the Strategic review, the ACCC considered that "to date, the Commission has not received sufficient information to determine whether there is effective competition in particular areas where some form of competitor infrastructure exists".[63] However the ACCC also considered that Telstra's suggestion of an infrastructure audit had merit:

> the Commission considers it appropriate to conduct a more comprehensive survey of infrastructure, as suggested in Telstra's submission to this review, as part of its monitoring of market developments which will assist with future declaration reviews or assessments of exemption proposals.

In the Strategic review, the ACCC has accordingly sought submission from parties about how such an audit might occur. The ACCC considers that such an audit might be useful in assisting the ACCC to judge the level of effective competition in particular geographic areas. The ACCC has in the past concluded that there should be an exemption granted to the LCS in the CBD areas of Sydney, Melbourne, Adelaide, Brisbane and Perth, and considers that it would be appropriate to continue such an

---

61 ACCC, *Telecommunications Infrastructure in Australia 2004*, June 2005, p. 17.

62 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 8.

63 ACCC, *Strategic review of the regulation of fixed network services—ACCC position paper*, June 2006, p. 16.

exemption.[64] However, the ACCC considers that, at this stage, before any audit has taken place, it would not be possible to be determinative about competitive infrastructure for the LCS outside of those CBD areas, nor would it be possible to assess how the presence of alternative infrastructure would affect the level of competition. Accordingly, the ACCC's consideration of the promotion of competition has proceeded on the basis of a national market outside of the exempted CBD areas.

The declaration of the unconditioned local loop service (ULLS) was designed to promote competition in the local telephony services market, with service providers supplying end-users with telephony services either as part of a package with high bandwidth carriage services or independently. Such competition has, however, taken some time to emerge with developments ongoing at this stage.

In the ACCC's draft decision, the ACCC noted that a possible alternative to using the ULLS to supply local calls would be the use of the local PSTN originating and terminating services. In the ACCC's strategic review, it has proposed that the local PSTN originating and terminating service be subsumed into the service description for the domestic PSTN originating and terminating access service. However the ACCC notes that the functionality of the services should not change. However the ACCC considers that, in the continued absence of a pre-selection determination covering local calls, and given the level of uncertainty regarding the way in which local calls will be routed and provided following network modernisation and increased usage of the ULLS, the use of PSTN origination and termination is unlikely to be a significant alternative to the LCS.[65]

Until the ULLS is more widely used by service providers and/or PSTN originating and terminating services can be used to supply local calls, service providers re-supplying local telephony services to end-users are likely to provide the main form of local telephony competition.

The ability of these service providers to compete effectively in the local telephony market through re-supplying local telephony services is largely influenced by the terms and conditions on which the LCS is are supplied to them. The charges paid by service providers to Telstra represent the overwhelming majority of the revenue received by service providers from their customers for those services. The wholesale supply of these services to service providers is not subject to effective competition, as outlined in the previous section.

Continued declaration of the LCS would therefore constrain the ability of suppliers of these services to influence competition in the downstream retail market. However, without declaration of this service, it is likely that, given these services are supplied in a wholesale market which is not currently subject to effective competition, access seekers may be either unable to procure access to the LCS, or access on reasonable terms and conditions. That is, in the absence of declaration of the LCS, it is unlikely that

---

[64] ACCC, *Future scope of the Local Carriage Service—final decision*, July 2002.

[65] The ACCC notes that Telstra has argued against the use of PSTN OTA for the supply of local calls, as discussed below in section 7.4.

competition in the downstream market will be sustainable, and therefore cannot be held to be effective in the absence of declaration at this stage. As a result, the ACCC is firmly of the view that continued declaration of the LCS is likely to promote competition in the downstream market for retail voice services.

In determining the extent to which declaration is likely to promote competition, the ACCC must also have regard to the extent to which it will remove obstacles to end-users gaining access to carriage services or services provided by means of carriage services (subs. 152AB(4)).

In this regard, fixed telephony services already have a high level of penetration in Australia (i.e. around 50 per cent of the population); continued declaration is not expected to increase the penetration of telephony services. It can, however, provide end-users with additional choices in terms of service provider, increased competition on the retail service dimensions, and, depending on the service provider's costs, lead to lower priced local calls for end-users. These benefits are likely to continue to be enjoyed on an ongoing basis by end-users who are unlikely to be served by alternative customer access infrastructure in the foreseeable future (i.e. the majority of residential end-users and business end-users except for large corporate and government users).

This conclusion is made in the context of a particular market definition, specifically one bounded by a specified time period limited to two years. After this period, the ACCC considers that a sufficient level of uncertainty regarding future developments of wholesale substitutes to the LCS may be resolved. This is likely to necessitate a re-evaluation of whether the continued declaration of the LCS is likely to promote competition, and where substitutes are found to be sufficiently effective, to forbear from continued regulation of the service. The ACCC notes that any results from an audit of infrastructure, as discussed above, could provide useful inputs into that re-evaluation.

Consideration of the pricing approach the ACCC would be likely to adopt in the event that it was required to determine prices for the LCS is discussed in section 10 of this report.

7.3 Will declaration achieve any-to-any connectivity?

As noted above, the concept of any-to-any connectivity is not always relevant in the declaration context. The ACCC considers that declaration of the LCS will have no impact on the objective of achieving any-to-any connectivity.

7.4 Will declaration encourage economically efficient use of, and investment in, infrastructure?

As discussed in section 3 of this report, when deciding whether declaration of a service will be in the LTIE, the ACCC is required to consider whether declaration would be likely to encourage:

- economically efficient use of infrastructure, and
- economically efficient investment in:

- the infrastructure by which listed services are supplied
- any other infrastructure by which listed services are, or are likely to become, capable of being supplied.

In determining the extent to which a particular thing is likely to encourage the efficient investment in other infrastructure, the ACCC must have regard to the risks involved in making the investment.

The ACCC is mindful that consideration of economically efficient use of and investment in infrastructure must be made in an environment where the LCS has been a declared service. Hence, the ACCC addresses these issues from the perspective of considering the likely consequences 'with' continued or varied declaration as opposed to those that could be reasonably expected 'without' declaration.

The ACCC's consideration of each of these decisions on economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are provided is outlined in turn below.

7.4.1 Submissions of interested parties

Given the natural monopoly characteristics of Telstra's local loop, Optus believes that the ULLS offers the best prospect of promoting competition in the LCS services market. The ULLS offers a way of enabling competition by allowing customers to choose their access services over the copper—thereby providing contestability to the local loop infrastructure. In this context, Optus argues that:

> … the ULLS service specifically targets the market failure that has previously lessened competition in both the wholesale and retail markets for local calling services.[66]

In its submission, AAPT stated that it is clearly inefficient to duplicate telecommunications facilities where unused capacity exists as this has the potential of promoting irrational competition. That is, an environment where service providers compete by pricing at the short-run marginal cost of the service rather than the long-run marginal cost plus a proportion for common costs. AAPT considers that:

> Such pricing behaviour is unsustainable but creates the illusion of an effectively competitive market.[67]

The Competitive Carrier Coalition (CCC) submitted that competitors in the LCS services market are likely to adopt different investment strategies that reflect the market conditions in different geographical locations and customer segments. As such, the CCC believes that:

---

[66] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 19.

[67] AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 7.

> … some competitors might not wish to invest beyond what is necessary to establish a pure reseller business… If a competitor can establish a position in the market as a pure reseller, they should be free to do so, and it should be acknowledged that this adds a useful element of competitive tension to a market, especially where facilities-based competition is nascent.[68]

In its submission Telstra's comments on investment focussed on the use of PSTN O/T to provide local calls. Telstra argues that the use of PSTN O/T to provide local calls is inconsistent with the efficient use of and investment in infrastructure. Additionally, Telstra considers that it is at odds with encouraging infrastructure-based competition. In support of this argument, Telstra stated that multi-basket preselection would need to be implemented by industry in order for local calls to be provided using the PSTN O/T and this would involve substantial costs, not only to Telstra but all carriers. Moreover, Telstra believes that:

> … these costs cannot be justified, as there are no benefits to be gained from the provision of local calls via preselection that are not already achievable through LCS.
>
> Use of PSTN OTA for the carriage of local calls would introduce inefficient call handling and trunking by all carriers. Instead of local calls staying in Telstra's PSTN, these calls would be transmitted from Telstra's local access switch ('LAS') via Telstra's inter exchange network to the access seekers point of interconnect into the access seekers switch and then back from the access seekers switch to Telstra's PSTN to either the same or a different LAS.[69]

In addition, Telstra submitted that using PSTN O/T to supply local calls would shift significant volumes of traffic into the trunk layer of the PSTN, requiring Telstra to invest many millions of dollars to augment capacity on that part of its PSTN. Access seekers would incur additional costs as they would need to increase their interconnect capabilities—i.e., the transmission systems to their switches to the point of interconnect and add switchports on their switches. Notwithstanding these additional costs to industry, Telstra believes that:

> … making PSTN OTA available for the provision of local calls is likely to slow the move to ULLS rather than hasten it. PSTN OTA provides a lower cost access-based solution for access seekers in CBD and metropolitan areas and hence reduces the attractiveness to access seekers of moving LCS to ULLS. Rather, access seekers would be able to obtain at least part of the gains simply from moving to PSTN OTA for the provision of local calls.[70]

7.4.2 Impact on efficient use of infrastructure

As indicated in section 3, the ACCC considers that efficiency has three major components – allocative, productive and dynamic. In general, each of these forms of efficiency is enhanced when the prices of given services reflect the costs of providing these services. In more competitive markets, service providers have a greater incentive to lower prices in order to win market share. Accordingly, this incentive helps push

---

68 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 3.

69 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 34.

70 ibid, p. 35.

prices towards costs, and thereby improves the efficient use of resources, and therefore infrastructure.

Where declaration is likely to promote competition in markets for carriage services or services provided by means of carriage services, the ACCC's competition analysis will generally help it to form a view about the impact of declaration on efficiency. For instance, where the ACCC finds that declaration can lead to greater competition in downstream markets by helping to ensure prices for the eligible service better reflect their efficient costs of provision, it is likely such declaration will also help promote efficiency in use of telecommunications services. By enabling greater competition in downstream markets, declaration would be expected to improve productive and dynamic efficiency in these markets by giving service providers the incentive to find lower-cost means of producing goods and services in downstream markets, and by encouraging both access providers and access seekers to invest and innovate in ways that will ensure they produce goods and services of a chosen quality at the lowest possible cost in the future. Further, the ACCC would expect allocative efficiency to be improved as it would be more likely that over time the final prices paid for retail services by end-users will better reflect the efficient costs of provision of these services.

In the language of subsection 152AB(2)(e), declaration will be expected to result in the more efficient use of infrastructure used to supply the eligible service. Conversely, a decision not to declare would, on this reasoning, lead to less competition in downstream markets and a less efficient outcome.

The ACCC therefore considers that, in the absence of declaration, Telstra is unlikely to be constrained in the pricing of services in the downstream market. As a result, in the absence of declaration Telstra is less likely to face the correct incentives to price its services in ways which promote the efficient use of infrastructure. Conversely, declaration provides access seekers with access to the declared service on reasonable terms and conditions, and in doing so is likely to place competitive pressure on Telstra such that all parties will face the correct incentives to price their services in ways which reflect more efficient use of the underlying infrastructure. Accordingly, the ACCC is of the view that continued declaration, as opposed to its cessation, is more likely to promote the efficient use of infrastructure.

Finally, in considering the impact of declaration of a service on the efficient use of telecommunications infrastructure, the TPA also requires the ACCC to consider whether it is 'technically feasible' to supply and charge for the eligible service when determining whether declaration would encourage the efficient use of infrastructure. In this regard, the ACCC must particularly consider:

- whether supply is feasible in an engineering sense (i.e. having regard to the technology that is in use or available)
- the costs of supply and whether the costs are reasonable
- the effects, or likely effects, of supply on the operation or performance of telecommunications networks.

Given that the LCS has been declared and provided since 1999, the ACCC believes it is technically feasible to provide a LCS.

7.4.3 Incentives for efficient investment in existing infrastructure

Issues relating to the impact of declaration on the maintenance, improvement and expansion decisions in respect of infrastructure used to supply the LCS were not specifically raised during this review.

The incentives for efficient investment in existing PSTN infrastructure are predominately driven by pricing and demand considerations. This investment could either be in existing PSTN infrastructure or in replacement network infrastructure, such as an IP based network.

The ACCC is of the view that, by enabling access, declaration provides competitive tension in the market such that it is reasonable to expect that incentives for efficient investment are likely to be promoted. Conversely, in the absence of declaration, competition is likely to place less pressure on the incumbent to invest efficiently. The ACCC is therefore of the view that continued declaration of the LCS is likely to promote incentives for efficient investment in existing infrastructure.

7.4.4 Incentives for efficient investment in new infrastructure

This aspect can be looked at from at least two perspectives—the incentives on Telstra to invest in new networks and the incentives on access seekers to invest in their own facilities or networks.

The supply of local call services using the LCS has enabled service providers to become familiar with the market and make more informed investment decisions. In addition, it has facilitated service providers to establish a customer base and steady cash flow before embarking on infrastructure investment. These factors reduce the investment risks which, in the context of an industry where investment is characterised by sunk costs and economies of scale, serves to reduce the barriers to market entry. In this way declaration is likely to have had a positive effect on investment by access seekers. In the absence of declaration, the ability of access seekers to acquire the LCS, or to acquire it on reasonable terms and conditions, would be inhibited and it is reasonable to conclude that access seekers incentives for efficient investment in new infrastructure would be distorted.

In relation to Telstra, the issue that needs to be addressed is whether continued declaration of the LCS is likely to impede Telstra's investment in PSTN replacement infrastructure. In other words, if the LCS declaration is continued, will there be sufficient incentives for Telstra to invest in new technologies, aimed at providing new and improved LCSs at presumably lower cost to end-users?

The ACCC notes that the LCS has been a declared service for an extended period of time. There is no information to suggest that Telstra has been unwilling to invest in infrastructure as a result of this declaration. Further, the ACCC notes that Telstra has recently announced plans to significantly modernise its core network, and considers that there is no evidence to suggest that the continued declaration of this service is likely to negatively impact on Telstra's incentives to undertake investment in this, or any other, new infrastructure.

7.5 ACCC's view

The ability of service providers to compete effectively in the local telephony market through re-supplying local telephony services is largely influenced by the terms and conditions on which local call services are supplied to them. The ACCC considers that continued declaration of the LCS would constrain the ability of dominant suppliers to unduly influence competition in the local telephony services market. This is likely to promote competition in that market and in the long distance telephony services market where local telephony services are bundled with long distance calls for customers who prefer to acquire those services from a single provider and thereby promote the interests of end-users.

In the ACCC's view, continued declaration of the LCS is likely to encourage efficient investment in infrastructure used to supply local telephony (and possibly other) services. It will continue to facilitate market entry and enable service providers to obtain information about demand characteristics and the likely responses of competitors, thus reducing the risks associated with infrastructure deployment. This will enable service providers to make efficient decisions about when to deploy competing facilities. Similarly, Telstra's incentives to efficiently invest in replacement technologies to deliver voice services will not be unduly affected by the continued declaration of the LCS.

In recognition of the previous exemption granted to the LCS in the CBD areas of Sydney, Melbourne, Adelaide, Brisbane and Perth, the ACCC considers that the continued declaration of the LCS should not apply in those same CBD areas.

The ACCC considers that the declaration should apply for three years from 1 August 2006. As noted above, there is currently considerable uncertainty about the likely take-up of alternatives to Telstra's wholesale local services. However, after two years, the ACCC expects that the uncertainty about the take-up of these alternatives and their implications for effective competition might be resolved.

A declaration of three years should mean that, at the commencement of the next declaration review (which must occur in the 12 months before the expiry of the declaration), the currently uncertain state of competition and infrastructure deployment should be more evident, and the ACCC will accordingly be better able to assess the appropriateness of continued declaration.

A three year declaration would also be consistent with the ACCC's position in its Strategic review of fixed network services, where it has decided to continue declaration of the ULLS and PSTN originating and terminating access services for three years.[71] A three year declaration period for the LCS would better allow the ACCC to synchronise future declaration reviews of these three related services.

[71] ACCC, *Declaration inquiry for the ULLS, PSTN OTA and CLLS—final determination*, July 2006.

8 Test for declaration – line rental service

8.1 Would declaration of the line rental service be in the LTIE?

As noted above, the ACCC may declare an eligible service if it is satisfied that the declaration is likely to result in the achievement of the following objectives:

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

In addition, where appropriate and where the ACCC considers it usefully facilitates its consideration of the matters under section 152AH(1) the ACCC has given consideration to the 'future with and without' test, expressed in the Sydney Airports case.[72] Applying this test requires the ACCC to contrast the outcome assuming the line rental service is declared against the outcome assuming the line rental service is not declared. The ACCC does not apply this test where it considers it does not helpfully assist it with determining the reasonableness of particular terms and conditions. The ACCC notes that while the 'future with and without' test can be applied explicitly, in most instances it is implicit in the ACCC's assessment.

The following is the ACCC's assessment of the impact of declaring the line rental service on the above objectives.

8.2 Will declaration promote competition?

The line rental service is an essential component in provision of retail telephony services such as local, long distance and international calls. These, and other, basic telephony services cannot be provided without the line rental service, which allows for access to the public switched telephone network.

While not currently declared, the line rental service is at present provided and priced through the supply of the LCS, and thus is effectively declared on a de facto basis. As indicated in section 6.2.2, the ACCC believes that the line rental service should be treated as a separate eligible service. It is the ACCC's view that the line rental service is a pre-requisite for the competition in provision of basic telephony services provided using LCS, and PSTN originating and terminating access. Further the line rental service is almost always bundled with the provision of local calls, and generally with long distance telephony. As such, the ACCC's reasoning on the promotion of competition when considering declaration of the LCS (in section 7) usefully informs the ACCC's analysis for the line rental service

---

[72] *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

The ACCC's market analysis leads to the conclusion that at this stage the wholesale market for the provision of line rental is not effectively competitive. Accordingly, the observed level of retail competition is heavily reliant upon resale of Telstra's line rental service. Without declaration, it is relatively more likely that access seekers may be either unable to procure access to WLR, or access on reasonable terms and conditions, to the detriment of competition. In the absence of declaration of a WLR service, it is unlikely that competition in the downstream market will be sustainable, and therefore cannot be held to be effective in the absence of declaration at this stage.

The ACCC notes again the prospect of an audit of competitive infrastructure, as proposed by Telstra, which is being examined in the ACCC's Strategic review of the declaration of fixed network services. As with the LCS, the ACCC considers that it is not possible to be determinative about competitive infrastructure for the WLR service outside of CBD areas, or on the effect that the presence of alternative infrastructure would have on competition. Accordingly, the ACCC's consideration of the promotion of competition is on the basis of a national market for WLR outside of the CBD areas of Adelaide, Brisbane, Perth, Melbourne and Sydney.

Telstra states:

> … Telstra submits that a basic access service should not be declared. Telstra has never in the past refused to supply basic access on reasonable terms and conditions.[73]

The ACCC does not consider that Telstra's arguments are sufficient. The ACCC has consistently held the view that where the market for the supply of an eligible service is not effectively competitive, then declaration (or continued declaration) of the service is likely to lead to improved terms and conditions of access relative to what would otherwise be the case. The ACCC's market analysis for the WLR service concluded that this market is currently not subject to effective competition. Accordingly, the ACCC considers that there is no reasonable basis to conclude that Telstra is either likely to continue to provide the service, or to continue to provide it on reasonable terms and conditions, in the absence of declaration.

A secondary consideration concerning the promotion of competition is the extent to which access seekers' ability to procure a line rental service on reasonable terms and conditions is likely to promote competition in broadband markets with respect to xDSL services. As outlined earlier, under current conditions consumers are required to purchase line rental in order to procure xDSL services on Telstra's network. Where it is part of either Telstra's or access seekers' competitive strategies to bundle fixed voice services with xDSL, any inhibition of access seekers' ability to purchase a WLR service, or to purchase on reasonable terms and conditions, is likely to inhibit competition. Accordingly, to the extent that part of the downstream retail market is characterised by a bundled product offering including xDSL services, competition in the market for retail broadband services is likely to be further promoted by the declaration of a WLR service.

---

[73] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 15.

As a result, the ACCC is firmly of the view that declaration of a WLR service is likely to promote competition in the downstream market for retail voice services. Declaration of the line rental service will promote competition in retail markets for telephony service, and may further promote competition for other retail services which require provision of line rental (e.g. provision of ADSL) as part of a bundle.

8.3 Will declaration achieve any-to-any connectivity?

As with the LCS, it appears that a declaration of the line rental service will have no impact on the objective of achieving any-to-any connectivity.

8.4 Will declaration encourage economically efficient use of, and investment in infrastructure?

In determining whether a declaration of the line rental service is encouraging the economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are supplied, the ACCC is mindful that such consideration must recognise that while the line rental service is currently not declared, the pricing of the LCS has always included the pricing of the line rental service (both directly and indirectly).

The ACCC believes that the 'future with or without' test is useful in this analysis.

8.4.1 Impact on efficient use of infrastructure

Telstra has claimed that without the declared line rental service, it would continue to provide the service on reasonable terms and conditions.[74] However, without declaration, Telstra has an incentive to price the service above competitive levels and/or restrict the supply of the service. Therefore, without the declared line rental service, the infrastructure required for the provision of the service would be likely to be underutilised, and prices for services would be likely to be inefficiently high. An inability to access the declared service on reasonable terms and conditions would therefore likely have the effect, as noted above, of reducing competition. By enabling greater competition in downstream markets, declaration would be expected to improve productive and dynamic efficiency in these markets by giving service providers the incentive to find lower-cost means of producing goods and services in downstream markets, and by encouraging both access providers and access seekers to invest and innovate in ways that will ensure they produce goods and services of a chosen quality at the lowest possible cost in the future. Further, the ACCC would expect allocative efficiency to be improved as it would be more likely that over time the final prices paid for retail services by end-users will better reflect the efficient costs of provision of these services.

---

[74] ibid.

8.4.2 Incentives for efficient investment in existing infrastructure

Issues relating to the impact of declaration on the maintenance, improvement and expansion decisions concerning infrastructure used to supply local services were not specifically raised during this review.

The incentives for efficient investment in existing PSTN infrastructure are predominately driven by pricing and demand considerations. This investment could either be in existing PSTN infrastructure or in replacement network infrastructure, such as an IP based network.

The ACCC is of the view that, by enabling access, declaration provides competitive tension in the market such that it is reasonable to expect that incentives for efficient investment are likely to be promoted. Conversely, in the absence of declaration, competition is likely to place less pressure on the incumbent to invest efficiently. The ACCC is therefore of the view that continued declaration of the LCS is likely to promote incentives for efficient investment in existing infrastructure.

8.4.3 Incentives for efficient investment in new infrastructure

This aspect can be looked at from at least two perspectives—the incentives on Telstra to invest in new networks and the incentives on access seekers to invest in their own facilities or networks.

The supply of line rental services in conjunction with the LCS declaration has enabled service providers to become familiar with the market and make more informed investment decisions. In addition, it has facilitated service providers to establish a customer base and steady cash flow before embarking on infrastructure investment. These factors reduce the investment risks which, in the context of an industry where investment is characterised by sunk costs and economies of scale, serves to reduce the barriers to market entry. In this way declaration is likely to have had a positive effect on investment by access seekers. In the absence of declaration, the ability of access seekers to acquire a WLR service, or to acquire it on reasonable terms and conditions, would be inhibited and it is reasonable to conclude that access seekers incentives for efficient investment in new infrastructure would be distorted.

In relation to Telstra, the issue therefore that needs to be addressed is whether continued declaration of line rental services is likely to impede Telstra's investment in PSTN replacement infrastructure. In other words, if a WLR service is declared, will there be sufficient incentives for Telstra to invest in new technologies—aimed at providing new and improved line rental services at presumably lower cost to end-users.

The ACCC notes that line rental has effectively been declared for an extended period of time. There is no information to suggest that Telstra has been unwilling to invest in infrastructure as a result. Further, the ACCC notes that Telstra has recently announced plans to significantly modernise its core network, and considers that there is no evidence to suggest that the continued declaration of this service is likely to negatively impact on Telstra's incentives to undertake investment in this, or any other, new infrastructure.

In addition, any likely increase in wholesale-based and facilities-based competition as a result of this declaration will provide further incentives for either Telstra and other providers to innovate and invest in alternative technologies (such as wireless), and next generation networks (such as fibre to the node) so as to improve the quality and lower the costs of providing WLR services over time.

Without the declared LCS and line rental service, the incentives for investment in new and innovative infrastructure would greatly diminish, as higher barriers to entry arising from high investment risk and lack of scale economies would exist. Telstra is relatively more likely to remain dominant in the wholesale provision of the declared service, and relatively less likely to face competitive pressure to invest and innovate.

8.5 ACCC's view

The ACCC's view is that a declaration of the line rental service would result in promotion of competition in markets for listed services, and will encourage the economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are supplied. Therefore the ACCC's view is that the line rental service should be declared. For the reasons outlined previously, the ACCC considers that the declaration should not apply within the CBD areas of Adelaide, Brisbane, Perth, Sydney and Melbourne.

For the same reasons as outlined above in section 7.5, the ACCC considers that it is appropriate to declare the WLR service for three years.

9 Service descriptions

During the inquiry process, a number of suggestions were made by market participants as to the appropriate service description for a WLR service. The suggestions ranged from declaring an additional ‘stripped down’ WLR service not provisioned for any voice features to declaring a fully featured WLR service incorporating switch-based add-on services.

The ACCC also considers that there are drafting changes that should be made from the draft service descriptions for both LCS and WLR. In the LCS service description, the ACCC has made the following changes to the draft service description:

- clarified the application of the LCS declaration in CBD areas to better reflect the content of the ACCC’s exemption granted in 2002[75]

- slightly altered the definition of Central Business District area

- updated the reference to Part 8 of the *Telecommunications Act 1997* to reflect that Part being repealed and substantively replaced by Part 4 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999*

- removed the notes section, on the basis that parties are now sufficiently knowledgeable about the access regime that the notes are unnecessary.

The ACCC has similarly made drafting changes to the WLR service description relating to the Central Business District area and a minor wording change relating to the types of calls that the WLR service is capable of making and receiving. More substantive issues are discussed in the remainder of this section.

9.1 ‘Stripped down’ WLR service declaration

Some interested parties argued that the ACCC should declare an additional ‘stripped down’ basic access service, which would not be provisioned for any voice services or features.

The CCC stated:

> The CCC submits that basic access should be offered as a separate declared wholesale service in two forms. Firstly, a ‘stripped back’ basic access service based on a line that is not provisioned for voice or additional voice services. This service would be intended for access seekers wishing to deliver a wholesale ADSL service or a similar service that did not require voice features.
>
> A second voice enabled basic access service should be offered for those wishing to deliver LCS.[76]

---

75 ACCC, *Future scope of the Local Carriage Service—Final decision*, July 2002.

76 Competitive Carriers’ Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 6.

ACN also stated:

> The bundling of access with local calls in the current LCS declaration also causes a range of flexibility problems for competitors. As noted in Prices Report, lack of flexibility in determining functionality of services is a key competitive constraint. This issue can be addressed by declarations that give competitors options in constructing competing offerings, in particular the option to take a pared down or fully featured access product.
>
> The lack of a basic, pared down, access service is a problem for VoIP providers. It means that VoIP cannot be a true competitor in the first telephone line market because, for most consumers, it can't be provided without the consumer already having and paying for a full service access line. Indeed there is an argument that Telstra should be required to provide ADSL broadband without forcing the customer to take a PSTN access line as well.[77]

However, SPC stated:

> There is no real point in developing a stripped down version. The end user has the choice of buying the access service and not using it for telephony services. The costs of maintaining and servicing the line would be essentially unchanged.[78]

The WLR service is declared with the intention of improving competition in the provision of calling services. However, the calls for a 'stripped down' access service appear to relate more to the current commercial requirements imposed by Telstra in its wholesale and retail ADSL products to maintain a basic access voice service. The ACCC does not consider that it would be appropriate at this point in time to declare a 'stripped down' variation of the WLR service.

9.2 Inclusion of switch-based add-on services

Several submissions also called for the inclusion of switch-based add-on services in the service description of WLR.

The CCC stated:

> Telstra offers additional ancillary services to its own retail customers, such as free home message service (i.e.: '101'), that the CCC understands are integrated into the voice switch as part of the access service. These additional switch-based services are offered at no additional retail cost but are not offered at all to wholesale customers. The CCC considers this anticompetitive and that declaration would go some way to remedying this.[79]

ACN also stated:

> The lack of declaration of Home Messages 101 as part of a fully featured access options means that competitors are unable to offer their customers a functionally comparable local/access

---

77 Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 6.

78 Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 4.

79 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 6.

> product using the current LCS declaration. This undermines one of the key competitive purposes of the LCS declaration.[80]
>
> ACN submits that the ACCC should declare a core featured basic access service including those features which Telstra provides to its retail customers at no additional charge.[81]

However, Telstra stated:

> Telstra submits that if the Commission determines to separately declare WLR, the service description should not specify the inclusion of add-on services, such as Telstra Home Messages 101. These add-on services are not an essential characteristic of basic access and do not represent a bottleneck that requires regulatory intervention. They can already be provided by competitors using their own infrastructure and/or services.[82]

The ACCC acknowledges that it may be complex and inefficient for access seekers to replicate the majority of Telstra's switch-based add-on features and that this may have the potential to have an impact on competition. However, the ACCC understands that Telstra currently provides the majority of these services in its commercial arrangements. The ACCC expects that Telstra will continue to provide these services on a commercial basis, and therefore that at this stage no explicit inclusion of these services in the service description for WLR is necessary.

Telstra currently does not make the Home Messages 101 service available to access seekers. However, the ACCC is of the view that home messaging services can be sourced competitively by access seekers by other means. Submissions throughout the inquiry process have not presented sufficient evidence in support of the contention that lack of access of Home Messages 101 provides a significant competitive detriment. Accordingly, the ACCC does not consider the lack of availability of Telstra's Home Messages 101 for access seekers to be a matter which requires regulatory intervention through an alteration to the service description for the WLR.

9.3 Wording modification

In its submission to the draft decision, Telstra proposed a modification of the wording of the WLR service description.

Telstra states:

> Telstra broadly agrees with the draft service description presented by the Commission in Appendix D of the draft report. Telstra has suggested only a minor change to this description to ensure that the phrase 'certain types of calls' is limited to voice call services delivered over the PSTN (specifically 'calls transmitted at 3.1khz bandwidth').[83]

---

80 Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 6.

81 Ibid., p. 8.

82 Telstra Corporation Limited, *Submission in response to the Local Service Review*, April 2006, p.24.

83 Telstra Corporation Limited, *Submission in response to the Local Service Review*, April 2006, p.24.

Telstra submitted that description of WLR service should read as follows:

> The line rental service is a line rental telephone service which allows an end-user to connect to a carrier or carriage service provider's public switched telephone network, and provides the end-user with:
>
> A. an ability to make and receive any 3.1khz bandwidth calls (subject to any conditions that might apply to particular types of calls) made over the public switched telephone network. These calls may include, for example, local calls, national and international long distance calls etc
>
> B. a telephone number[84]

The ACCC views this proposal as acceptable and has modified the WLR service description accordingly.

9.4 ACCC final view on the WLR service description

The ACCC's final view is to maintain the WLR service description proposed in the draft decision, with the minor wording adjustment proposed by Telstra and the minor drafting changes discussed above. The ACCC does not propose to declare a separate 'stripped down' WLR service, or to explicitly require the provision of value added switch-based add-on services through inclusion in the service description.

However, the ACCC notes that it has made this decision based on its expectation that Telstra will continue to provide switch-based add-on services to access seekers on a commercial basis. If Telstra's commercial agreements change to exclude these services, and if this were to be shown to be causing competitive detriment, the ACCC would be likely to revisit these matters to determine whether the LTIE would be better served through explicit alterations to the service description for the WLR.

---

[84] ibid., p.25.

10 Pricing principles for local services

Once a service is declared, the ACCC may be called upon to arbitrate access disputes between access seekers and access providers concerning the terms and conditions of access to the service. It may also have to accept or reject access undertakings provided by access providers.

The ACCC is required by s.152AQA of the TPA to determine, in writing, principles relating to the price of access to declared services. The determination may also contain price-related terms and conditions relating to access to the declared service. The ACCC must make such a determination at the same time as, or as soon as practicable after, the ACCC declares a service. The ACCC is also required to publish a draft of the determination, invite submissions on the draft and consider any submissions received, before it makes a final pricing determination.

Once the ACCC has made a pricing principle determination, it must have regard to the determination if it is required to arbitrate an access dispute.[85] The ACCC considers that, although a party may argue against the principles being applied to its particular case, pricing principles will guide commercial negotiation of access by providing greater certainty as to the ACCC's views on reasonable access prices.[86]

This section contains the ACCC's pricing principles determination for the LCS and WLR services (together the 'declared services'). The ACCC has considered and analysed the submissions of interested parties in response to its Discussion Paper released in April 2005 and Draft decision released in March 2006. The ACCC's draft pricing principle determination was released in that draft decision.

Section 152AQA(2) of the TPA outlines that a pricing principle determination made by the ACCC may also contain price-related terms and conditions relating to access to the declared service. The ACCC has considered possible draft price-related terms and conditions relating to access to the declared services in section 10.8 and is seeking comment on those prices by 31 August 2006.

10.1 Legislative criteria

An important consideration in ensuring that access to declared services would promote the LTIE is whether the terms and conditions of access (including the price or a method for ascertaining the price) are reasonable. The mere provision of access by an access provider may not be sufficient to promote the LTIE. The terms and conditions under which access is provided are also important in determining the degree to which the LTIE is promoted by declaration. Typically, the price will be a particularly significant term of access.

---

85 *Trade Practices Act 1974* s.152AQA(6)

86 See: Commonwealth, *Trade Practices Amendment (Telecommunications) Bill 2001*, pp. 10, 18.

The ACCC's role in assessing terms and conditions generally revolves around assessing undertakings and arbitrating disputes. In these circumstances, the TPA requires that the terms and conditions of access are reasonable.[87] Sections 152AH and 152AB of the TPA set out the matters the ACCC must have regard to when determining whether particular terms and conditions are reasonable:

- whether the terms and conditions promote the LTIE of carriage services or of services supplied by means of carriage services, which in turn are achieved by:[88]
  - promoting competition in markets for telecommunications services
  - achieving any-to-any connectivity in relation to carriage services that involve communication between end-users and
  - encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied
- 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
- 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 and
- the economically efficient operation of a carriage service, a telecommunications network or a facility[89]

This does not, by implication, limit the matters to which regard may be had.[90]

A more detailed discussion of these legislative criteria and their application in determining access pricing principles can be found in the ACCC's *Access Pricing Principles – Telecommunications – a guide*.[91]

---

[87] The ACCC must also ensure that the terms and conditions in undertakings and any arbitration determination are consistent with any Ministerial pricing determination in place. See s. 152CH of the TPA.

[88] s. 152AB(2) of the TPA.

[89] s. 152AH(1) of the TPA.

[90] s. 152AH(2) of the TPA.

[91] ACCC, *Access Pricing Principles Telecommunications – a Guide*, July 1997.

10.2 Alternative pricing approaches

The ACCC considers that there are two main alternative pricing principles for pricing the declared services—the retail-minus-retail-costs (RMRC) approach and the cost-based approach.

RMRC is a 'top-down' approach that takes the retail prices paid for the declared service and deducts the avoidable costs of retailing the service to end-users to calculate an access price. A cost-based approach, in comparison, is a 'bottom-up' approach that models the costs of the various network elements necessary for use in the service (and also, typically, allocates common costs).[92] Where the retail service and wholesale service are the same product, and where retail prices are strictly cost-based, the two pricing approaches will lead to (approximately) the same access price.

However, the approaches will more often lead to divergent access prices. Of particular relevance are the following two scenarios:

- If retail prices are held below costs (which may be the case due to the government's retail price control regime), a RMRC approach will lead to lower access prices than a cost-based approach.
- If retail prices are above total (wholesale + retail) costs, then the access seeker is making some level of economic profits. A RMRC price will be higher than cost-based prices because it will reflect this level of economic profit. The access provider would accordingly retain these profits from the RMRC price at the expense of access seekers and/or access seekers' end-user customers. A cost-based approach would not preserve this profit.

It can be seen that the relative level of retail prices and the cost of providing a service can significantly affect the results under the different pricing principles.

In its Discussion Paper, the ACCC requested submissions on the appropriate pricing principles to apply to any continued declaration for the LCS and/or any new declaration of a WLR service. The ACCC sought comment on both the RMRC principle and a form of cost-based alternative.

10.3 The ACCC's draft pricing principles

Following consideration of submissions in response to the discussion paper, the ACCC issued draft pricing principles in Chapter 9 of its draft decision for the Local services review.[93] The draft pricing principles proposed that a retail-minus-retail-cost (RMRC) pricing principle should be maintained as an interim pricing approach.

However the ACCC noted that the decision between a RMRC pricing principle and a cost-based pricing principle was not clear-cut. In particular, the choice between the two

---

92 The ACCC has typically chosen to apply the Total Service Long Run Incremental Cost (TSLRIC) approach when applying a cost-based pricing methodology.

93 ACCC, *Local services review—draft decision*, March 2006, p. 84.

principles depended significantly on the relativity between retail prices for the local call and line rental products and the cost of providing the LCS and WLR products.

10.4 Submissions from interested parties

Five parties—ACN, CCC, Optus, Southern Phone Company and Telstra—made submissions relating to pricing principles in response to the ACCC's discussion paper. Three parties—CCC, Optus and Telstra—made further submissions in response to the draft pricing principles in the ACCC's March 2006 draft decision.

ACN

ACN submitted while retail-minus pricing was appropriate in 1999, it is now increasingly flawed and open to exploitation by Telstra:

> … Telstra's practice of pricing local/access significantly lower as part of its bundled offerings than the unbundled price used for calculating LCS, completely undermines the retail minus approach.[94]

ACN also stated that the retail-minus approach is inconsistent with the ACCC's approach to pricing other declared services, including local/access type declarations such as PSTN O/T and ULLS. ACN argued that a geographically averaged Total Element LRIC approach, such as that adopted by the FCC, may be more appropriate so as to provide competitors flexibility with regard to which elements of the bundle (i.e., local calls, other calls, access and related services) they want to provide.

Competitive Carriers' Coalition

The CCC submitted in its submission to the discussion paper that the LCS pricing principles should be changed from retail-minus to a cost-based approach, with a wholesale cap for calls.

> That is, the wholesale price of the LCS should be charged on the same basis as interconnection rates for wholesale PSTN originating and termination rates, reflecting the recovery of the cost of infrastructure and systems necessary to deliver the service to the particular access seeker.
>
> While the retail minus pricing principle approach has the benefit of simplicity of implementation, it does so at the cost of consistency across the treatment of related services. There would seem to be no need to continue this inconsistency if costs are fully recovered.[95]

The CCC reiterated support for a cost-based pricing approach in its submission to the draft decision.[96]

---

94 Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 7.

95 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 5.

96 Competitive Carriers' Coalition, *Local services review draft decision March 2006—Competitive Carriers' Coalition (CCC) submission*, April 2006, p. 4.

Optus

Optus submitted in its submission to the discussion paper that the current regulatory construct for LCS is leading to higher prices for long distance and other bundled services. In Optus's view, a retail-minus construct with a starting point of Telstra's unbundled local calling price could not be in the interests of end-users.

That said, Optus argued that:

> … it may be that other arrangements, specifically the Government's retail price control regime, may provide some protection from Telstra's conduct. Indeed the retail price controls may be appropriate protection given it is the combination of the ACCC's approach to LCS pricing and retail price cap arrangements that motivate Telstra's conduct.[97]

Optus concluded that the ACCC should:

> … adopt a TSLRIC pricing principle for each of the LCS and WBA services where the price is found to be less than RMRC.[98]

However, Optus closed its submission by setting out its 'Bridge to Broadband' proposal, under which it would promise to implement competitive infrastructure in return for apparently arbitrarily determined LCS and line rental prices of 10 cents per call and $25 per month respectively.

In its submission to the draft decision, Optus repeated its support for setting WLR and LCS on a TSLRIC basis where this is found to result in a price below that resulting from an RMRC approach.[99]

Southern Phone Company

Southern Phone Company submitted that:

> … any LCS declaration must recognise the circumstances of regional Australia and allow a continued cross subsidy in service provision between regional and metro areas.[100]

Telstra

Telstra, in its submission in response to the discussion paper, stated:

> In Telstra's view the long-term interest of end-users, and in particular the ACCC's objectives for sustainable infrastructure-based competition in telecommunications, require that the pricing of LCS and wholesale basic access move toward recovery of efficient costs.[101]

---

[97] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 15.

[98] ibid., p. 9.

[99] Optus, *Optus comments on ACCC's draft decision on the Local Carriage Service review*, 30 May 2006, p. 2.

[100] Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 4.

[101] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 2.

Telstra also submitted that:

> …the application of RMRC…results in further inefficiency because the deduction of 'avoidable' rather than 'avoided' costs fails to fulfil the purpose of RMRC, that is to render an access-provider indifferent between retail and wholesale supply, and encourage efficient supply. In the event that the ACCC persists with RMRC, then retail costs actually avoided must be used, PSTN originating and terminating access prices must be adjusted to ensure cost recovery … and unbundled starting prices must continue to be used to minimise the 'ratchetting down' effect [i.e., Telstra's wholesale price falls in response to a fall in retail prices].[102]

Telstra further stated that it:

> … advocates joint pricing of LCS and wholesale basic access to ensure cost recovery across the services and to permit flexibility by negotiation between access seekers and access providers, enabling both to price more innovatively.[103]

Telstra appeared to revise its position somewhat in its submission to the draft decision, stating that it considered it would be appropriate to set the price for LCS on a RMRC basis but then charge higher PSTN OTA prices:

> While Telstra has set [in its PSTN OTA and LCS undertakings] the individual price point for LCS using a Retail Minus Retail Cost ('RMRC') approach, full cost recovery is ensured by setting PSTN OTA prices at a level that allows full cost recovery across the full range of services that use the IEN component of the PSTN. Further, Telstra's recent increase in the wholesale basic access price allows Telstra to fully recover the efficient costs of the CAN component of the PSTN.[104]

This more strongly advocated an option briefly mentioned in Telstra's submission to the draft decision[105] and appeared to step away somewhat from Telstra's previous opposition to the RMRC approach. However, Telstra still stated that any pricing principle would have to be consistent with full cost recovery (but no more).[106] The ACCC does not consider that this position is significantly different from Telstra's support of a cost-based approach in its submission to the discussion paper.

However Telstra did revise its position on the use of avoided or avoidable costs. Its submission to the draft decision stated that:[107]

> Telstra remains of the view that the avoidable cost approach remains the theoretically correct approach.

---

[102] ibid., p.4.

[103] ibid.

[104] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 27.

[105] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 28.

[106] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 26.

[107] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 32.

which was a significant departure from its position as extracted above. Telstra did not explicitly reiterate its opposition to independent pricing of services from the submission to the discussion paper. However it did submit that if independent pricing was adopted, it would have to be in such a way that arbitrage opportunities were not allowed.

10.5 Relativity between costs and retail prices

As noted in the ACCC's draft decision, market perceptions of the costs of providing the declared services differ. The relative level of retail prices and costs, as noted above in section10.2, may mean that the RMRC and cost-based approaches lead to significantly different access prices.

Accordingly, the relative levels of retail prices for the retail local call and line rental services and the costs of producing the declared LCS and WLR services is a significant factor in assessing which pricing principle is most appropriate for the declared services.

During this inquiry, Telstra submitted that:

- The TSLRIC[108] of wholesale line rental is **[c-i-c]** (PIE II estimate, 05/06, GST exclusive); and

- The TSLRIC of a wholesale local call is **[c-i-c]** (PIE II estimate, 05/06, GST exclusive, ADC exclusive)[109]

No other participants submitted robust cost estimates to this inquiry to substantiate their claims about the costs of providing the declared services. Submitting parties however had previously provided estimates in course of the ACCC's assessment of Telstra's core services undertakings:[110]

- Optus claimed that adjusting the PIE II model to the ACCC's preferred inputs would result in a TSLRIC price of local calls of **[c-i-c]** cents in 2003-04[111]

- AAPT suggested that reasonable adjustments to call holding times in the PIE II model would result in a TSLRIC price of local calls of **[c-i-c]** cents.[112]

---

[108] While it is not clear from Telstra's statements, the ACCC has presumed that its TSLRIC estimates are in fact TSLRIC+ estimates.

[109] Telstra presented estimates for the ADC exclusive TSLRIC of local calls of [**c-i-c**] in 2005/06, rising to [**c-i-c**] by 2007/08—Telstra, *Submission in Response to ACCC Discussion Paper Entitled Local Services Review 2005*, 28 June 2005, p. 27. The estimated TSLRIC of wholesale line rental was in a separate presentation to the ACCC— Telstra, *Local services inquiry*, August 2005, p. 5 (confidential). The ACCC has presumed that the estimates are consistent.

[110] ACCC, *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004.

[111] Optus, *Optus Submission to the Australian Competition and Consumer Commission on Telstra's Undertaking for Domestic PSTN Originating and Terminating Access, Unconditioned Local Loop Service and Local Carriage Service*, March 2004, p. 35.

Following recent price increases, Telstra's prices for Homeline Part are now $31.95 (inclusive of GST, $29.04 exclusive of GST) and **[c-i-c]** (inclusive of GST, **[c-i-c]** exclusive of GST) for WLR.

Telstra's maximum allowable retail local call prices are 20 cents, exclusive of GST.[113] The ACCC has previously accepted wholesale prices for local calls of 13.61 cents as proposed in Telstra's undertaking prices for the 2004/05 year.

Optus considered on the relative level of retail prices and costs that:

> … it may be reasonable to define a market for local calling services in rural and regional areas… In these areas it has been suggested that Telstra holds the price of its services below cost… However, it is questionable as to whether prices are being held below cost. As has been argued by Optus in its submission on Telstra's core service undertakings and the PIE II cost model estimates, the actual cost of supplying services in these areas may be lower than estimated.[114]

In its draft decision, the ACCC made the following observations on the relative level of access prices under an RMRC approach and a TSLRIC+ cost-based approach:

- Relative to the situation at previous assessments, the gap between TSLRIC+ costs estimated by Telstra's PIE II model and access prices has narrowed significantly, primarily due to substantial increases in the wholesale price for line rental.

- As noted previously by the ACCC, appropriately defined TSLRIC+ costs of providing local calls and line rental are likely to have declined significantly in recent periods, and may now be below access prices set under the current pricing approach.[115] While Telstra's estimates appear to place the TSLRIC+ costs at slightly above access prices, the ACCC considers that these estimates are not robust.

- The ACCC has ongoing concerns about the ability of Telstra's PIE II model to produce reasonable estimates of TSLRIC+ costs in all geographic regions and only uses the model in the absence of a robust alternative cost model. However, even Telstra's unadjusted PIE II estimates for 2005/06 are close to current RMRC-determined access prices. The ACCC has adjusted the model in a severely limited way in the past to produce what it considers to be conservative upper bound estimates of reasonable TSLRIC+ estimates. If the ACCC was to

---

112 AAPT, *Telstra's Undertakings for Domestic PSTN Originating and Terminating Access, Unconditioned Local Loop Service and Local Carriage Service: Submission to the ACCC by AAPT Limited*, August 2003, p. 60.

113 The price for a retail local call can exceed this value where the price of line rental is discounted.

114 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 14.

115 ACCC, *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004, p. 52.

do so again, it is likely that adjusted PIE II estimates for the period are likely to eliminate the gap between the PIE II estimates and current access prices.

- While conclusions cannot yet be drawn about the results from a robust cost model, it might be expected that the results would similarly result in cost-based access prices below current access price.

Telstra's submission to the draft decision challenged the ACCC's conclusions about the relative levels of costs and RMRC-determined access prices. It submitted that:

- An extrapolation of ACCC data used in its 2000 assessment of Telstra's PSTN OTA undertaking would imply that CAN costs are increasing.

- The IEN cost pool is extremely insensitive to traffic volumes, and with a decline in PSTN traffic volumes, the unit cost of PSTN traffic could be expected to be increasing.

- The ACCC should not be drawing any conclusions about possible outcomes from the development of a cost-based access pricing model.

The ACCC considers that neither of the two pieces of evidence presented by Telstra is particularly conclusive. The ACCC considers that more recent information than data from the 2000 undertaking assessment, including the information presented by Telstra itself to this declaration inquiry, supports the ACCC's view concerning the level of line costs. The ACCC does not consider that using six-year old data and using a simple extrapolation of two points is a robust modelling approach. The ACCC also notes that, while it is true that traffic volumes may be decreasing, it might also be expected that total IEN costs are decreasing as Telstra pursues modernisation of its core network, and that the net result of the two effects is difficult to judge.

The ACCC considers that the debate over the level of costs further demonstrates the need for a robust cost model. It accordingly intends to actively pursue the rapid development of this model. The ACCC rejects any implication from Telstra that it has predetermined views on the outcome of the cost model exercise. The ACCC has simply noted that evidence from Telstra's own PIE II cost model, Telstra's own submissions to this inquiry (e.g. 'Telstra's recent increase in the wholesale basic access price allows Telstra to fully recover the efficient costs of the CAN'[116]) and critiques of problems with PIE II available to the ACCC[117] all suggest a certain outcome.

---

[116] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 27.

[117] In the ACCC's assessment of Telstra's current ULLS undertakings, it has commissioned a report by Analysys on the PIE II model—Analysys, *Review of specific issues in Telstra's PIE II model*, 24 May 2006. Interested parties to the same assessment process have also submitted critiques of the model—the CCC has submitted a report by Marsden Jacob associates, and Optus has submitted a paper as well as resubmitting past reports on PIE II - Marsden Jacob Associates, *Comments on discussion paper—Telstra's undertaking in relation to the Unconditioned Local Loop Service*, May 2006 and Optus, *Telstra's PIE II model*, May 2006.

However the ACCC has no predetermined views on the outcomes from a robust cost model and rejects any allegations of bias. The ACCC intends that the development of the cost model will occur in a collaborative manner. As part of that collaboration, the ACCC will consult with industry on the requirements for such a model.

10.6 Reasonableness of alternative pricing principles under s. 152AH

The LCS and WLR services currently offered by Telstra are priced in accordance with 'Option 1' as outlined by the ACCC in the Discussion Paper.[118] The LCS is priced on a RMRC basis, with the retail cost adjustment to the LCS incorporating avoidable retail costs for both the LCS and line rental. WLR is priced to the access seeker without adjustment for avoidable retail costs.

The ACCC's assessment has considered the two pricing principles identified in section 10.2—the RMRC approach and the cost-based approach.

The ACCC has effectively applied a modified 'with and without' test to the assessment of alternative pricing principles. It has assessed the outcomes which could reasonably be expected given prevailing market conditions under an RMRC pricing principle, and compared those outcomes with those which could be expected if a cost-based pricing principle applied. The two alternatives are contrasted against each other to provide a comparative analysis of their ability to best fulfil the reasonableness criteria in s. 152AH.

The ACCC's pricing principle follows the assessment against the reasonableness criteria. Implementation issues are discussed separately in section 10.2.

10.6.1 The long-term interest of end-users

10.6.1.1 Promotion of competition

As stated in the ACCC's draft decision, the effect on the promotion of competition of the two possible pricing principles depends on the relative levels of costs and retail prices or, alternatively, the relative levels of cost-based access prices and RMRC-determined access prices.[119]

Broadly, the ACCC regard anything that promotes (damages) competition, everything else being equal, as enhancing (damaging) the LTIE. When considering whether a given pricing principle will promote competition, it is appropriate to examine the

---

[118] ACCC, *Local Services Review 2005*, April 2005, pp. 47-48.

[119] The ACCC uses these terminologies interchangeably. The ACCC noted in section 10.2 that if the total (retail + wholesale) cost of provision of a declared service exceeds the retail price for the retail service, cost-based access prices will also exceed RMRC-determined access prices. Similarly, if retail prices exceed total (retail + wholesale) costs, RMRC-determined access prices will exceed cost-based access prices. However it should be kept in mind that total cost, which constitutes both wholesale and retail cost, for the retail service is distinct from the cost of provision of the declared service, which does not include retail costs.

impact of the proposed principle on the relevant markets, and compare the state of competition in those markets under each alternative principle.

Where costs exceed retail price

The ACCC considers that where costs exceed retail prices (and hence, by definition, cost-based access prices exceed RMRC-determined access prices), an RMRC approach is more likely to promote competition in the retail markets for local calls and line rental than a cost-based pricing approach.

An RMRC approach will preserve competitive neutrality between Telstra and access seekers at the retail level. An access seeker who efficiently retails the services to end-user customers will be able to sell the products at a price that allows them to compete with Telstra. This ability to compete may allow access seekers to reach sufficient scale to allow them to build their own infrastructure and allow facilities-based competition.

Comparatively, a cost-based approach would mean that access seekers would face a significantly higher access price. The ACCC expects that access seekers would find it more difficult to compete in the retail market when facing this higher price and that entry into the retail market by access seekers would be curtailed. In turn, this inability to enter the resale market may curb the development of facilities-based competition, as access seekers would be unable to develop the sufficient market scale to justify infrastructure build.

However Telstra has argued that a cost-based approach would be competitively neutral. This is because Telstra submits that access seekers will be competing over the full bundle of fixed voice services (line rental, local calls, national long distance, international and fixed-to-mobile calls). Accordingly, it argues, 'access seekers will recoup their costs across the total bundle of PSTN services'.[120]

Similarly, Telstra argued in its submission to the discussion paper that the current retail price controls on line rental and local calls required it to supply retail line rental and local calls below cost and that:

> Competitive neutrality requires that access seekers purchase wholesale services at cost-based prices and share responsibility for losses at the retail level, instead of imposing all the losses on Telstra. [121]

As noted by the ACCC in its draft decision, Telstra's argument has merit if Telstra would, were the service not declared, receive cross-subsidies from other sources that it would not receive if it granted access to an access seeker. It also requires that these subsidies are not simply profits but are necessary to make up the difference between line rental and local call retail prices and the cost of providing the declared LCS and WLR.

---

120 Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 31.

121 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 49.

For a cost-based approach to promote competition, the ACCC would need to be satisfied that access seekers would be able to cross-subsidise in the same way as Telstra. As noted previously by the ACCC, there are three obvious areas of possible cross-subsidy that Telstra could access:

- above-cost pricing of related services such as voice calls
- external funds such as the Universal Service Fund and other government subsidy programs
- unrelated services such as wholesale and retail DSL services.

If access seekers can access the same subsidies, competition is unlikely to be harmed by a cost-based approach if costs exceed retail prices. However, if access seekers cannot access those subsidies, then a cost-based approach would be likely to be detrimental to competition. These subsidies are discussed further below in section 10.6.2.

Overall, a RMRC approach would seem to be more likely to promote competition if costs exceed retail prices.

Where retail prices exceed costs

The ACCC considers that where total costs are below retail prices (and hence cost-based access prices are lower than RMRC-determined access prices), a cost-based pricing approach is more likely to promote competition in the retail markets for local calls and line rental than a RMRC-based pricing approach.

When retail prices exceed total costs, a RMRC-based pricing approach would mean that access seekers would pay an amount for the declared service that preserves an element of profits for Telstra. Accordingly, access seekers would face a higher cost structure than Telstra, which would only face the costs without the profit level. The ACCC accordingly considers that this would not promote competition, as access seekers would be limited in the amount they could compete with Telstra in the retail market, who would have lower costs and be maintaining economic profits in the wholesale product price.

Comparatively, a cost-based pricing approach would not include this element of profit, and access seekers and Telstra would be competing on an equal basis.

However, as discussed above, the prospect of facilities-based competition is a relevant consideration. Alternatives to the declared LCS and WLR, such as the ULLS or WiMAX, are available to access seekers. It could be argued that a RMRC-based pricing approach would encourage the build of infrastructure because access seekers would be keen to avoid paying the economic profits to Telstra. Comparatively, a cost-based pricing approach would discourage facilities-based infrastructure build because the benefits of switching to the alternative infrastructure would be smaller.

The countervailing argument is that a RMRC-based pricing approach would inhibit facilities-based competition because it would prevent access seekers developing sufficient scale to justify infrastructure build, while a cost-based approach would encourage it by encouraging the development of scale through resale competition.

However the ACCC also notes that there are further incentives to encourage facilities-based infrastructure build, such as decreased reliance on the access provider's infrastructure and increased control over facilities, product differentiation and quality control.

The ACCC does not consider it has sufficient information available to it to quantify the relative size of these effects on facilities-based competition. However it considers that it can conclude that:

- resale competition will be better promoted by a cost-based pricing approach
- the effect on facilities-based competition is unclear and depends on competing incentives.

Accordingly, it is likely that on balance competition is better promoted by a cost-based approach when total costs are below retail prices.

In its draft decision, the ACCC noted Optus' 'Bridge to Broadband' proposal that submitted that LCS and WLR prices should be set low (at 10c a call and $25 a month respectively) so that access seekers could develop scale in the market. In exchange access seekers would enter a deed to implement new broadband infrastructure. While recognising that the proposal recognises the ACCC's analysis above, the ACCC retains concerns with the approach, particularly given that it is unclear how the prices are determined, and considers that it may not be in accordance with the statutory criteria. Accordingly the ACCC does not consider that it should adopt this approach as a pricing principle.

Overall

It is difficult to form a firm view on the relative merits of the RMRC and cost-based pricing principles in the absence of reliable information about the relative levels of costs and retail prices. If total costs exceed retail prices then an RMRC approach is more likely to promote competition, but if retail prices exceed total costs then a cost-based approach is more likely to promote competition.

10.6.1.2 Efficient use of infrastructure

Efficient use of infrastructure is interpreted in standard economic efficiency terms of moving prices closer to underlying costs to achieve a closer matching of users' valuation of the services, at the margin, with the cost to the economy of providing those units. As with the promotion of competition, the effect of the alternative pricing principles will depend on the relative level of total costs and retail prices.

Inefficient use of infrastructure can occur either due to the price for that infrastructure being too high or too low. Accordingly, a RMRC-based access price, which will frequently diverge from the costs of provision of the declared service, could lead to either over or under use of the declared services, depending on whether the retail prices are below or above the cost of provision respectively. Accordingly, allocative efficiency would not be expected to be promoted by the use of a RMRC principle, although it might be expected to lead to productive efficiency gains in the retailing of the declared service.

Comparatively, a cost-based approach by definition leads to access prices aligned with the costs of production of the declared service. It would be expected therefore that the cost-based pricing approach would better lead to allocative efficiency gains. The productivity gains in retailing would similarly be promoted under a cost-based approach. However, as noted in the ACCC's draft decision, current bundling approaches mean that the bundled retail prices for services are not necessarily aligned with the costs of provision. Accordingly, allocative efficiency gains from a cost-based pricing approach may be small.

Also relevant are the longer-term dynamic and productive efficiency gains that may result from the development of facilities based infrastructure. As discussed in section 10.6.1.1, the relative effects of different pricing approaches on the development of facilities-based infrastructure will depend on the relative level of costs and prices. It will also depend on competing factors—the fact that access seekers typically need a certain scale to justify infrastructure build and the fact that a lower access price will reduce the incentive to build alternative infrastructure. The benefits for dynamic and productive efficiency will be uncertain as a result.

However some broad conclusions can be drawn:

- Where total costs are above retail prices, a RMRC-based approach might better encourage facilities-based competition by encouraging access providers to develop sufficient scale in the retail market to make infrastructure build attractive. Once alternative infrastructure was built, it might be expected that both Telstra and the facilities-based competitor(s) would face incentives to innovate and improve their products and seek lower costs over time.

- Comparatively, where total costs are below retail prices, a cost-based approach might be expected to better lead to facilities-based competition and lead to innovation and lower costs.

Accordingly, while it is possible to see potential dynamic and productive efficiency gains in the use of infrastructure over time, which pricing approach would best encourage those efficiency gains is uncertain.

10.6.1.3 Efficient investment in existing and new infrastructure

The ACCC considers that this criterion requires that there be incentives for Telstra and other potential facilities-based entrants to make economically justifiable investments in the infrastructure by which the declared services are provided. The appropriate pricing principle again depends on the relativities between costs and prices.

Where retail prices are below costs

Where retail prices are below costs, the ACCC firstly notes that an RMRC approach should encourage efficient investment in retailing infrastructure, as competition in retailing will be the primary form of price-based competition between Telstra and a reselling access seeker.

The ACCC also considers that it could be argued that a RMRC approach would tend to encourage investment in infrastructure that could support facilities-based competition. As noted above, this is because access seekers generally need to develop a sufficient scale to justify competing infrastructure build, because it reduced the risk associated with the large capital outlay. However it is not clear that such investment will necessarily occur or be efficient if it does occur, as access seeker's build will not be based on the relative costs of the resale product and the facilities-based infrastructure, to the extent that the RMRC-based price does not reflect costs. In particular, it could be anticipated that access seekers, knowing that they can currently purchase access at below cost and that they would be constrained by the pricing restrictions of the retail price controls from recovering the cost of investment, would be unlikely to build alternative infrastructure.[122]

This argument was put forward by Telstra in its submission to the draft decision:

> To ensure that investment in the PSTN in Australia continues, investors must have an expectation that the costs of building and maintaining the PSTN will be recovered from prices paid for services that are provided over the PSTN. This is not limited to efficient investment by Telstra in its own PSTN, but extends to ensuring that the appropriate signals exist for investment in alternative PSTN or substitute infrastructure. If access seekers are not provided with the correct build/buy signals then efficient investment will not occur. In particular, if access prices simply allow access seekers to use Telstra's PSTN below the efficient cost of provision then access seekers will have no incentive to invest in alternative infrastructure, even when it is more efficient.[123]

Telstra therefore argues that a cost-based approach would better encourage efficient investment compared to a RMRC approach. The ACCC notes Telstra's argument that it would also face reduced incentives for investment. However it is uncertain how this sits with Telstra's previous argument that recovery over all services supplied on the PSTN is the significant issue and that recovery for these particular LCS and WLR declared services is not significant.

The ACCC notes that a cost-based approach would face a similar restriction to that noted above for RMRC pricing. If retail prices are currently below costs, then access seekers will be restricted in recovering the cost of investment from prices. It seems unlikely that access seekers would build infrastructure in those circumstances. Access seekers would be unlikely to develop sufficient scale for investment under a cost-based approach, meaning that any infrastructure build would be high risk.

Overall the ACCC considers that a RMRC-based pricing approach might be more likely to encourage efficient investment when costs are above retail prices. While there would be distortions under either approach due to the low prices, the RMRC approach would be more likely to allow access seekers to develop sufficient scale to consider investment.

---

[122] While competing access seekers or infrastructure-based competitors are not subject to the retail price controls, the ACCC considers that they would have to compete with Telstra and thus are effectively restricted by the controls.

[123] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 26.

Where retail prices exceed costs

Where costs are below retail prices, the ACCC considers that a cost-based pricing principle is more likely to promote efficient investment in existing and new infrastructure. Access seekers will face the appropriate signals for investment as the access price would properly reflect the actual cost of provision of the LCS and WLR services, thus enabling them to accurately assess build-buy decisions. Telstra would similarly face appropriate incentives to invest in its infrastructure as it would recover the costs of that investment.

10.6.1.4 Any-to-any connectivity

The ACCC does not consider that any-to-any connectivity is likely to be affected by the choice of pricing principle.

10.6.2 Legitimate business interests

The ACCC generally considers that the legitimate business interests of access providers require an access price that at least provides a normal commercial return on prudent investment but do not extend to achieving a higher than normal commercial return.

In its draft decision, the ACCC noted that the LCS and WLR would be provided over the CAN, which the ACCC considers is the dominant source of Telstra's market power. The ACCC also considered that Telstra would be likely to continue investment in the CAN for strategic reasons and that there reasons would also have to be considered.

As noted in section 10.6.1.1, a crucial question that needs to be considered is how Telstra recovers the costs of provision of the line rental and local call services. The relativity between costs and prices is again significant in determining which pricing approach would be most appropriate.

If retail prices for local calls and line rental are below total costs, the ACCC considers that it can be presumed that Telstra would be unable to recover the costs in retail prices were the service not declared. The question therefore is whether Telstra would, were the service not declared, receive cross-subsidies from other sources that it would not receive if it granted access to an access seeker. It is also significant whether these cross-subsidies are necessary to make up any gap between retail prices and access prices and are not merely lost economic profits. The ACCC has noted three possible areas of cross-subsidy:

- above-cost pricing of related services such as voice calls
- external funds such as the Universal Service Fund and other government subsidy programs
- above-cost pricing of unrelated services such as wholesale and retail DSL services.

If Telstra's legitimate business interests are to be preserved, Telstra needs to be able to access sufficient cross-subsidies when it provides LCS and WLR access such that it can recover the costs of providing the services and achieve a normal commercial return, but not more than this.

As noted in the ACCC's draft decision, if Telstra does not recover enough from these cross-subsidies, then government policy is to force Telstra to make losses and it is arguable that those losses should be preserved in access prices as well given that it would still incur them without declaration. However the ACCC does not consider that this is the case.

Telstra has submitted that it does receive cross-subsidies from other voice services.[124] When LCS and WLR access is provided, the ACCC considers that it can reasonably be assumed that Telstra can no longer access any cross-subsidy from voice services, as access seekers bundle other voices services with local calls and line rental in the retail market. Accordingly, Telstra would not have access to this cross-subsidy.

Telstra agrees that it receives a cross-subsidy from the Universal Service Fund but argues that the value of the cross-subsidy is small:[125]

> It is correct that Telstra receives a very small contribution toward CAN costs (including Telstra's own contributions) from the USO, which across all basic access services amounts to less than $1 per month per service.

The ACCC considers that Telstra will continue to access this subsidy where declaration of the LCS and WLR is made. It notes that, if Telstra's submission is accurate, the small amount of the subsidy may indicate that it is less significant, although it is clearly a relevant consideration.

However Telstra submits that other government subsidies relating to ADSL should not be considered to be a contribution towards CAN costs.[126] It also submits that:

> Neither Telstra's retail nor wholesale prices for ADSL services include a contribution to the CAN line costs.[127]

although as noted in the ACCC's draft decision this submission does not concord with comments attributed to Telstra's Chief Financial Officer:

> Telstra's finance chief John Stanhope made a very telling comment at a recent investment bankers' conference. The advent of high-speed internet services using DSL over copper wires was the very best thing that could have happened to Telstra, he said. This is because it allows Telstra to pay for its national copper and fibre network a second time. A double dip on returns on capital. Nothing could make a CFO's heart sing louder, Stanhope mused.[128]

The ACCC notes again that it is difficult given these conflicting messages to assess whether Telstra is recovering some CAN costs in its ADSL charges. However it considers that to the extent Telstra is recovering CAN costs through such unrelated

---

[124] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 31.

[125] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 29.

[126] Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 29.

[127] Telstra, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 42.

[128] M. Sainsbury, 'Coonan's out of the loop on separation', *The Australian*, 23 June 2005, p. 27.

products, Telstra would be able to access this cross-subsidy when access to the declared service is provided.

Accordingly, the ACCC considers that the choice of pricing principle when total costs exceed retail prices comes down to a judgement call about how much subsidy Telstra receives from government subsidies and ADSL charges. A RMRC pricing approach would be appropriate if any extra costs are made up from these sources, as Telstra would recover its legitimate costs. A cost-based approach might lead to over-recovery, as Telstra would continue to receive these other cross-subsidies. Accordingly any cost-based pricing principle would require an assessment of this amount of cross-subsidy and perhaps an adjustment to the access price.

Where total costs are below retail prices, a cost-based approach would lead to Telstra's legitimate business interests being protected, as the cost-based prices would include a normal commercial return. A RMRC-based approach would be likely to include more than a normal commercial return and ensure more than is necessary to protect Telstra's legitimate business interests. Accordingly the ACCC considers that a cost-based approach would better satisfy the requirements of this criterion. The consideration of the amount of cross-subsidy would also be relevant when total costs are below retail prices, and a cost-based access price might similarly need adjustment.

10.6.3 The interests of persons who have rights to use the declared services

The interests of persons who have rights to use the declared service are best served by a pricing principle which provides them with a reasonable opportunity to compete in the market. The interests of persons who have rights to use the declared services would also appear to be served by minimising any regulatory uncertainty which may arise through changes to pricing principles.

As discussed above in the consideration of the promotion of competition in section 10.6.1.1, the effect of the pricing principles depends on the relative level of costs and prices. If total costs exceed retail prices, a RMRC pricing principle is likely to better give access seekers the opportunity to compete. If total costs are below retail prices, a cost-based approach will be likely to better give access seekers the opportunity to compete.

If a cost-based pricing principle was adopted, the ACCC considers that the use of some type of glide path from RMRC-determined access prices could minimise uncertainty and regulatory shock to both access seekers and Telstra. However at this stage of establishing a broad pricing principle the ACCC does not consider it necessary to decide whether this is necessary.

10.6.4 Direct costs of providing access to the declared services

Direct costs are those costs necessarily incurred in the provision of access. This criterion requires that an access price should not be inflated to recover any profits the access provider may lose in a dependent market as a result of the provision of access.[129]

---

[129] Explanatory memorandum to Trade Practices Amendment (Telecommunications) Bill 1996

A cost-based pricing approach clearly by definition better reflects the direct costs of providing access than an RMRC-pricing approach. When retail prices exceed total costs of provision for the retail service, it can be seen that an RMRC-based access price will preserve an element of profit in the access price and hence not reflect direct costs. Where retail prices are below total costs, an RMRC-based access price will be below the direct cost of provision of the declared service and hence not reflect direct costs.

However as noted in the ACCC's draft decision, the applicability of this criterion is somewhat less certain when retail prices are below total costs. Telstra would be constrained by retail price controls from recovering these costs directly from the services in question in the absence of declaration and this would continue to happen when providing access to the declared service. It is uncertain whether the direct cost criterion applies in the same way under such a scenario. Arguably, the direct costs of providing access cannot be the full cost if the loss on the services would have been incurred anyway.

However, the ACCC considers that, generally, a cost-based pricing approach better takes into account the direct costs of providing access to the declared service.

10.6.5 Operational and technical requirements

The ACCC considers that operational and technical requirements are not likely to be affected by the choice of pricing principle.

10.6.6 ACCC's final view

The above assessment leads to the conclusion that:

- If costs are below the RMRC access price for the service, then a cost-based approach would be more likely to be reasonable.
- if RMRC access prices are below costs, then a RMRC approach would be more likely to be reasonable.

The relative levels of price and cost is clearly a crucial factor in determining whether a RMRC or cost-based pricing approach is most appropriate under the reasonableness criteria. As noted in section 10.5, this is an area of considerable debate and uncertainty.

However the ACCC notes that market perceptions of the costs of providing the declared services differ. Access seekers appear to believe that the retail prices of both services would be significantly above total costs of provision. Comparatively, data provided by Telstra for the 2005-06 year suggest that TSLRIC+ costs remain above retail prices for local calls (and are projected to rise over the coming period), but at or slightly below retail prices for unbundled line rental. The ACCC notes that the gap is not significant and has narrowed since the last pricing principle determination.

While the ACCC continues to have reservations about the ability of PIE II to produce reasonable TSLRIC+ estimates in all geographic regions, it notes that in the absence of a robust cost model little alternative guidance is available to it at this stage. The ACCC does not consider that it can be definitive about the relative levels of costs and retail prices in the absence of a robust cost model. The ACCC does not consider that PIE II is capable of producing reliable estimates of costs in all geographic areas due to a number of problems with its construction and assumptions. Although the ACCC notes that a number of the ACCC's concerns with PIE II may have less effect on the calculation of costs in metropolitan areas, it considers that PIE II is not capable of producing robust results in regional areas.

The differing market perceptions of prices and costs meant that all interested parties submitted that the ACCC should adopt a cost-based pricing approach for the LCS and WLR services (although some access seekers made this view conditional on finding that cost-based pricing would result in access prices below RMRC access prices). All parties also considered that they would be better off under such an approach. Access seekers submitted that a cost-based pricing approach would result in lower access prices, while Telstra argued that a cost-based pricing approach would lead to more appropriate cost recovery and higher access prices.

The ACCC considers that no definitive view can be made on which pricing principle to adopt, but notes that in the absence of a robust cost model capable of producing reliable estimates of costs in all geographic regions it would be difficult to conclude that cost-based pricing should be adopted.

However the ACCC considers that, once it has constructed a robust cost model, capable of producing reliable cost estimates in all geographic regions, it should seek to implement a cost-based pricing approach. While the choice between RMRC and cost-based pricing approaches is closely balanced on an assessment of the reasonableness criteria, the ACCC notes that the evidence presented to this declaration review suggests that retail prices and RMRC access prices currently exceed cost-based prices, particularly for WLR.

The ACCC also considers that moving towards a future implementation of a cost-based pricing approach is appropriate for the following reasons:

- greater consistency with pricing of other access services
- widespread industry support for a cost-based model
- greater relevance for the pending development of the cost model
- certainty for industry about future pricing.

The ACCC intends to consult with industry on the development of the cost model, and the implementation of a cost-based pricing approach, at an appropriate time.

The ACCC's view is therefore to adopt an interim RMRC pricing approach. The ACCC will seek to implement a cost-based pricing approach for the declared services once it has access to a robust cost model, and will consult on issues relating to the transition to cost-based pricing at that time.

10.7 Implementation Issues

10.7.1 Avoidable or avoided costs

In its submission to the discussion paper, Telstra argued that the ACCC should use avoided retail costs when determining an RMRC pricing approach. However the ACCC considers that the use of avoidable retail costs for the two services, rather than those costs actually avoided by Telstra, is more appropriate. In its draft decision the ACCC stated that it considered avoidable retail costs for the two services remained the most appropriate measure under the statutory criteria.[130]

Following the draft decision, Telstra has changed its position in its submission to the draft decision and now submits that:[131]

> Telstra remains of the view that the avoidable cost approach remains the theoretically correct approach.

The ACCC considers that, given the efficiency and neutrality considerations outlined in its analysis in the draft decision, and the widespread industry support for the use of avoidable costs, that avoidable retail costs for the line rental and local call products should be used in determining RMRC prices for the WLR and LCS.

10.7.2 Benchmark retail price

In the past, the ACCC has defined the benchmark retail starting price for the RMRC approach by reference to the Telstra retail products consisting of line rental and local calls only, HomeLine Part and BusinessLine Part. Telstra's prices for those services are cheaper when taken as a part of one of its bundled products, such as its HomeLine Complete or BusinessLine Complete plans, where Telstra also supples national long distance, international and fixed-to-mobile calls.

As outlined in the draft decision, the use of unbundled prices has the benefit that it allows Telstra pricing flexibility to response to competition. However it may allow Telstra to price squeeze reselling access seekers by offering retail customers significantly lowered bundled local call prices. Access seeker parties submitted to this declaration review that such price squeezes were a realistic concern. For example, Optus submitted that:[132]

> Telstra has consistently gamed the LCS regulatory framework since it was introduced.
>
> This gaming, regrettably, has been facilitated by the ACCC's laissez faire attitude on LCS. Telstra has, as result [sic], successfully managed to squeeze the margin earned by competitors using LCS.

Optus consequently submitted that an RMRC pricing approach should not be used.

Comparatively, using bundled prices better addresses price squeeze concerns but at the cost of Telstra's flexibility to set retail prices for its services. There is also the possibility that access seekers could engage in 'ratchetting down'. This is the situation where access seekers lower their retail prices below Telstra's and Telstra lowers its retail prices in response, causing the access price to fall. This may limit Telstra's ability to compete in response to facilities-based competition as Telstra would be less likely to

---

130 ACCC, *Local services review—draft decision*, March 2006, p.102-105.

131 Telstra, *Telstra's submission in response to the Local Services Review,* April 2006, p. 32.

132 Optus, *Optus comments on ACCC's draft decision on the Local Carriage Service ('LCS') Review*, May 2006, p. 2.

pursue price reductions due to not wanting to pass on discounts to resale customers. It may also lead to free-riding on reductions in resale prices by access seekers who do not build their own facilities. This free-riding would be at the expense of both Telstra and other providers that have built competing infrastructure and are engaging in price competition.

The ACCC considers that, overall, unbundled prices remain a more appropriate benchmark retail price due to the fact that bundled prices might restrict Telstra's retail pricing flexibility and perhaps encourage ratchetting-down. The ACCC considers that price squeeze behaviour is better dealt with through use of the anti-competitive conduct provisions in the TPA and notes that Telstra is currently the subject of an ACCC investigation concerning such behaviour.

10.7.3 Joint or independent pricing

While issues relating to the use of avoidable or avoided costs and the appropriate starting benchmark retail price are exclusive to the RMRC pricing principle, the issue of joint or separate pricing of the LCS and WLR products is relevant to both the ACCC's interim RMRC approach and the future cost-based approach. The ACCC considers that the following discussion and conclusion applies equally to both pricing approaches, but notes that it may be necessary to revisit the issue when the cost-based pricing approach is being implemented.

Separate pricing is the scenario where each product is priced according to its own costs or its own retail price less retail costs. Joint pricing is where the pricing is set such that the total combined access price for the two services is set to recover the cost of providing both declared services or alternatively where the retailing costs for both local calls and line rental are subtracted from the price of a combined retail product (such as HomeLine Part).

No submission considered that one per-call price to recover both line rental and LCS costs was appropriate. The ACCC considers that this approach lacks flexibility.

Telstra, in its submission to the discussion paper, argued for a bundled two-part tariff approach to pricing the LCS and WLR, suggesting that such an approach would provide flexibility in allocating common costs or attributing retailing costs, while still recovering the combined costs of provision of both services.[133] Telstra claimed that pricing line rental and the LCS separately is undesirable because of the risk that the ACCC will incorrectly allocate costs between the two services.[134]

The ACCC does not consider that a joint two-part tariff provides more flexibility or less risk than a separate pricing approach. Access providers and access seekers are free to negotiate how costs should be allocated if they wish. Further, if the ACCC was calculating access prices during an arbitration or assessing prices in an undertaking,

---

[133] Telstra, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 31.

[134] Telstra, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005,pp. 60-61.

some allocation of common costs or of retailing costs would still have to take place eventually to determine the two access prices. It is not clear why this would be any different under a joint price compared to under a separate price.

The ACCC noted in its draft decision that Telstra's submission to the discussion paper suggests that there is flexibility in cost allocation:

> ...under the current joint pricing mechanism, access seekers can purchase wholesale basic access at full retail prices and LCS at the retail price minus the combined (LCS + basic access) avoidable cost or basic access and LCS at their respective RMRC.[135]

The ACCC considers that this demonstrates both that access seekers and access providers can negotiate their own pricing arrangements and also that it is feasible to allocate costs to the services separately.

The ACCC also notes that Telstra's submission to the draft decision similarly acknowledges that separate pricing is possible in its discussions of the purchase of bundles or stand-alone products.[136]

The ACCC considers that there is little benefit in joint pricing. Separate pricing of services allows the LCS and WLR to be purchased separately as required and both joint and separate pricing require some allocation of common costs or of retailing costs. Accordingly the ACCC considers that separate pricing of the services should be adopted.

10.8 Indicative prices

10.8.1 Introduction and background

Section 152AQA of the TPA states that the ACCC must determine pricing principles for a declared service. In section 10.6, the ACCC stated that it would adopt an interim RMRC pricing approach for the LCS and WLR services, but would seek to implement a cost-based pricing approach once a robust cost model becomes available.

Section 152AQA(2) states that a pricing principles determination may also contain price-related terms and conditions. This section allows the ACCC to specify a price or prices when it makes a pricing principles determination. However the price or prices will be indicative only.[137] Section 152AQB similarly states that the ACCC may specify model terms and conditions for 'core services', which include the PSTN OTA, ULLS and LCS.

---

135 Telstra, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 60.

136 Telstra, *Telstra's submission in response to the Local Services Review*, April 2006, p. 32.

137 *Vodafone Australia Ltd v ACCC* [2005] FCA 1294.

The ACCC has in the past issued indicative prices as part of an LCS pricing principle determination[138] and has also issued model price terms and conditions for the LCS.[139]

Both indicative prices and model price terms and conditions are designed to provide guidance to access providers and access seekers involved in negotiating the terms and conditions of access to services, particularly as they would be taken into account by the ACCC in any arbitration of access disputes. They can also act as a guide to parties considering providing access undertakings to the ACCC for particular services.

Indicative prices and model prices provide this guidance by giving parties an idea of the ACCC's views on the appropriate pricing for the declared service.

However the ACCC notes that indicative access prices set out in a determination are non-binding on parties to arbitrations or undertaking assessments. While the ACCC would ordinarily see these access prices as appropriate in a general sense, it must look at specific issues, raised by the parties in particular arbitrations or undertakings, on their individual merits. As such, there will remain some potential for an arbitration determination or an approved undertaking to depart from the indicative prices.

In this Local Services Review, the ACCC is considering the appropriateness of determining indicative prices that would apply for the LCS and WLR under the interim RMRC pricing principle that will initially be used to price the services. These interim prices would apply while the ACCC finalises its assessment of Telstra's undertakings for the PSTN OTA and LCS.

The ACCC's most recent determination relating to the pricing of LCS and line rental was in the October 2003 model prices determination. That determination specified two alternative sets of prices to apply until 2004-05:

- Where the avoidable retail costs for both line rental and local calls were deducted from local call retail prices only, a price of 13.61c per call for the LCS and a price for the wholesale line rental service of $256.36 a year for residential end-user customers and $381.27 a year for business end-user customers.
- Where the avoidable retail costs for both line rental and local calls were deducted from their respective retail prices, a price of 18.23c per call for the LCS and a price for the wholesale line rental service of $206.66 a year for residential end-user customers and $331.57 a year for business end-user customers.

It was not considered appropriate to provide model prices beyond that time due to the review of the declaration scheduled for 2005-06. The ACCC understands that the first of these pricing structures has been the one used by Telstra and access seekers.

---

[138] ACCC, *Local Carriage Service pricing principles and indicative prices—final report (revised),* April 2002.

[139] ACCC, *Final determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003.

Given that the final decision in this Local Service Review is to continue the declaration of the LCS and to declare a WLR service, the ACCC now wishes to provide further guidance in the form of updated indicative prices for the 2006-2007 year.

The ACCC considers that any indicative prices that it establishes for 2006-2007 will be of an interim nature. They will stay in place while the ACCC undertakes more detailed work on assessing efficient LCS and WLR costs and prices. On 22 March 2006 Telstra lodged access undertakings specifying price-related terms and conditions upon which it undertakes to meet its standard access obligations to supply the PSTN OTA and LCS. The ACCC is evaluating those undertakings and has released a discussion paper seeking comment from interested parties. The ACCC is currently considering responses received to this discussion paper. The ACCC also notes its intention to pursue the development of a fixed network cost model and its intention of seeking to implement a cost-based pricing principle once that is achieved.

Nevertheless, the ACCC considers that it is important to provide some certainty for the interim period while this further work is undertaken in the undertaking assessment, in order to assist as a starting point for any commercial negotiations.

The ACCC notes that its approach to RMRC pricing has changed since the October 2003 model prices determination. Those model prices allowed for the avoidable retail costs of the line rental service to be deducted from either line rental prices or local call prices. As noted above, access seekers elected to have the avoidable retail costs of the line rental service deducted from the retail local call price. In part, this reflected the fact that line rental was not declared.

The ACCC considers that it is more appropriate that the avoidable costs of retailing a service are deducted from the service that causes the avoidable retail costs. Given that the ACCC has now separately and formally declared a WLR service, it would be more appropriate that the avoidable retail costs of the line rental service be deducted from the retail price of the line rental service. While this will relatively increase LCS prices, there will be a corresponding decrease in WLR prices.

10.8.2 Indicative prices for LCS and WLR for 2006-07

The October 2003 model prices determination was issued over two years ago. Furthermore, the determination did not specify prices extending beyond 2004-05.

The ACCC accordingly considers that it is appropriate to consider updating those prices. The ACCC notes that Telstra has, in the intervening period, changed its retail prices for unbundled local calls and line rental. It could also be expected that avoidable retail costs for these two services may have changed in that time.

The ACCC has obtained the retail prices for Telstra's HomeLine Part and BusinessLine Part products from Telstra's customer terms on its website:[140]

[140] Telstra, *Our customer terms, Basic telephone service section, Part —HomeLine Plans*, 5 July 06, viewed 17 July 2006, <http://www.telstra.com.au/customerterms/docs/hf_fixed_homeline.pdf> and Telstra, *Our customer terms, Basic telephone service section, Part D—Business Phone Services*, 5 July 2006, viewed 17 July 06, <http://www.telstra.com.au/customerterms/docs/bg_fixed_bps.pdf>

Table 10.8.1 Telstra retail prices for HomeLine Part and BusinessLine Part, July 2006

	HomeLine Part	BusinessLine Part
Line rental	$29.05 ex GST	$31.77 ex GST
Local calls	20c ex GST	20c ex GST

It is necessary to deduct avoidable retail costs of line rental and local calls from these prices to obtain the RMRC prices for the LCS and WLR. The ACCC has also obtained estimates of Telstra's average avoidable retail costs for these two services from retail and wholesale cost information contained in Telstra's Regulatory Accounting Framework (RAF) accounts for 2004-05. The ACCC has used a methodology to calculate the avoidable retail costs for these two services that was proposed by Telstra in a submission in support of its recent PSTN OTA and LCS undertakings.[141] The ACCC is yet to fully assess Telstra's undertaking and supporting submissions, or the submissions of interested parties, in that undertaking assessment. Given that the prices being calculated here are only draft indicative prices, the ACCC's use of this methodology does not at this stage imply that the ACCC has accepted Telstra's methodology or results in this process or the undertaking assessment.

Telstra's approach states that the avoidable retail costs for these two services in the RAF comprise organisational, product and customer costs and the cost of capital. The only adjustment made to these avoidable retail costs for these services is to remove installation costs from the product and customer costs. Volume data for retail access line and local calls are obtained from schedule 8 from the RAF accounts.

However the ACCC, consistent with its position in 10.7.3 above, considers that the avoidable retail costs for line rental should be deducted from line rental. This is in contrast to the deduction from local calls performed by Telstra.

Table 10.8.2 Telstra's avoidable retail costs and volumes for end-user access and local calls, 2004-05 RAF

	End-User Access	Local Calls
4-1 Organisational ($m)	[c-i-c]	[c-i-c]
4-2 Product and Customer ($m)	[c-i-c]	[c-i-c]
Cost of Capital ($m)	[c-i-c]	[c-i-c]
Total Retail Costs ($m)	[c-i-c]	[c-i-c]

141 Telstra, *Telstra's submission in support of its undertakings dated 22 March 2006*, March 2006. p. 30.

Volume (m)	[c-i-c]	[c-i-c]
Unit avoidable retail costs for line rental and local calls	**$5.47/mth**	**2.54c/call**

In the ACCC's LCS model prices determination, a number of adjustments were made to the values in the RAF accounts to provide a better representation of the avoidable retail costs of these two services that would be incurred if Telstra only supplied these products at the wholesale level.[142] Those adjustments have not been made for the purposes of these draft indicative prices, but the ACCC notes that it would be open for such adjustments to be made.

As can be seen in Table 10.8.2, the average avoidable costs for the two services were unitised by the number of retail lines and number of retail local calls made by Telstra customers. The use of Telstra retail usage figures reflects the fact that the ACCC is seeking to find the long run avoidable retail costs for the two services and all costs are avoidable in the long run.

Accordingly, the ACCC has obtained the following estimates of Telstra's avoidable retail costs for line rental and local calls:

Table 10.8.3 ACCC estimate of avoidable retail costs for line rental and local calls

Line rental	$5.47 per line per month
Local calls	2.54 cents

As the RAF does not distinguish between residential and business customers, the ACCC applies the same avoidable retail cost value for local calls and line rental to residential and business customers. The ACCC notes again that in the past the LCS has been priced by deducting the $5.47 of avoidable retail costs for the line rental service from the retail price of local calls.[143] However, following the separate and explicit declaration of a WLR service, the ACCC considers it more appropriate that the avoidable retail costs for line rental be deducted from the service that incurs them.

The ACCC also notes Telstra's claim for an adjustment for absorbing the effect of the GST under the 22c GST-inclusive price cap on local calls.[144] This adjustment was used

[142] ACCC, *Final determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p. 96.

[143] Telstra's recent undertaking continues this previous pricing structure. The $5.47 per line per month translates to an additional 8.41c of avoidable retail costs of the line rental service being deducted from retail local call prices.

[144] Telstra, *Telstra's submission in support of its undertakings dated 22 March 2006,* March 2006. p. 31.

by the ACCC in its 2003 model prices determination.[145] The ACCC considers at this stage that the theory behind this adjustment continues to be appropriate, even though the imposition of the GST was over 6 years ago. This is because both the GST and the 22c retail local call price cap remain in place. Accordingly the ACCC proposes at this stage to increase the LCS price by 0.23c to reflect the proportion of the GST that should be allocated to access seekers.

Deducting these avoidable retail costs for the line rental and local call products from the retail prices listed above gives the following draft RMRC wholesale prices for WLR and LCS:

Table 10.8.4 Draft indicative prices for WLR and LCS

	Residential	**Business**
WLR	$23.57 ex GST	$26.30 ex GST
LCS	17.69c ex GST	17.69c ex GST

The ACCC is now seeking comment from interested parties on these draft indicative prices and the approach taken by the ACCC to calculate them. Submissions should be provided by no later than **31 August 2006**. However the ACCC is not seeking further comments on the choice of pricing principle or decisions on implementation issues. Comments should be limited to the application of the principle as outlined in section 10.8 of this document.

10.9 ACCC's final determination on pricing principles

The ACCC's final determination is that an interim RMRC pricing principle should be adopted until such time as the ACCC has a robust cost model available. In implementing the interim RMRC pricing principle, the ACCC will use:

- avoidable retail costs for the two services rather than avoided retail costs
- unbundled benchmark retail prices
- separate pricing of the two services.

The ACCC will seek to implement a cost-based pricing approach once a robust cost model, capable of producing reliable estimates of costs in all geographic regions, is available.

The ACCC is seeking comment on the draft indicative prices for the LCS and WLR proposed in section 10.8 of this document. Interested parties should provide submissions by **31 August 2006**.

145 ACCC, *Final determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p. 88.

Appendix A. List of submissions

Submission to discussion paper (April 2005)

AAPT	11 July 2005
Australian Communications Network	6 June 2005
Competitive Carriers’ Coalition	6 June 2005
Optus	12 July 2005
Southern Phone Company	14 July 2005
Telstra	28 June 2005

Submission to the draft decision (March 2006)

Competitive Carriers’ Coalition	28 April 2006
Optus	31 May 2006
Telstra	28 April 2006

Appendix B. Former LCS service description

The local carriage service is a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end user in the same standard zone.

Definitions

Where words or phrases used in this declaration are defined in the *Trade Practices Act 1974* or the *Telecommunications Act 1997*, they have the meaning given in the relevant Act.

In this Appendix:

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies;

standard zone has the same meaning as in Part 8 of the *Telecommunications Act 1997*;

telephone calls are calls for the carriage of communications at 3.1kHz bandwidth solely by means of a public switched telephone network.

<u>Note:</u>

If a carrier or a carriage service provider supplies 'declared services' (whether to itself or to other persons), the carrier or carriage service provider is taken to be an 'access provider' and the declared services are taken to be 'active declared services' (section 152AR(2) of the TPA). The 'standard access obligations' of access providers in relation to active declared services are set out in sections 152AR(3), 152AR(5), 152AR(6), 152AR(7) and 152AR(8) of the TPA.

An access provider must, if requested to do so by a service provider, take all reasonable steps to ensure that:

a) the technical and operational quality of the active declared service supplied to the service provider is equivalent to that which the service provider provides to itself (section 152AR(3)(b) of the TPA); and

b) the service provider receives, in relation to the active declared service supplied to the service provider, fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself (section 152AR(3)(c) of the TPA).

If a service provider uses active declared services supplied by an access provider in order for it to provide carriage services and/or content services, the access provider must, if requested to do so by the service provider, give the service provider billing information in connection with the services (section 152AR(6) of the TPA). The billing information provided must comply with the Trade Practices Regulations (section 152AR(7) of the TPA).

Access providers also have other standard access obligations under section 152AR of the TPA.

The terms and conditions of access to a declared service are as agreed between an access seeker and an access provider. Failing agreement, the terms and conditions of access are as set out in an undertaking that has been accepted by the ACCC, or, as determined by the ACCC following an arbitration. In addition, model terms and conditions relating to compliance with the standard access obligations are contained in the approved TAF Access Code and may also be relevant.

Appendix C. LCS service description

The local carriage service is a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone. However, the local carriage service does not include services where the supply of the local carriage service originates from an exchange located within a Central Business District Area of Sydney, Melbourne, Brisbane, Adelaide or Perth and terminates within the standard zone which encompasses the originating exchange.

Definitions

Where words or phrases used in this declaration are defined in the *Trade Practices Act 1974* or the *Telecommunications Act 1997*, they have the meaning given in the relevant Act.

In this Appendix:

Central Business District Area means the exchange service areas that are classified as CBD for the purposes of the ordering and provisioning procedures set out in the Telstra Ordering and Provisioning Manual as in force on the date of effect of the renewed declaration.

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies;

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

telephone calls are calls for the carriage of communications at 3.1kHz bandwidth solely by means of a public switched telephone network.

Appendix D. Line rental service description

The line rental service is a line rental telephone service which allows an end-user to connect to a carrier or carriage service provider's public switched telephone network, and provides the end-user with:

(a) an ability to make and receive any 3.1khz bandwidth calls (subject to any conditions that might apply to particular types of calls), including, but not limited to, local calls, national and international long distance calls; and

(b) a telephone number

except where the supply of the line rental telephone service is within the Central Business District Area of Sydney, Melbourne, Brisbane, Adelaide and Perth.

Definitions

Where words or phrases used in this declaration are defined in the Trade Practices Act 1974 or the Telecommunications Act 1997, they have the same meaning given in the relevant Act.

In this Appendix:

Central Business District Area means the exchange service areas that are classified as CBD for the purposes of the ordering and provisioning procedures set out in the Telstra Ordering and Provisioning Manual as in force on the date of effect of the declaration.

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies.