

Fostering Open Competition Through Access Pricing Agreements

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Introduction

Recent amendments to the *Trade Practices Act 1974* (the Act) have changed the environment within which access to services in the telecommunications industry are determined. One change has been to afford two important functions to the Australian Competition and Consumer Commission. The Commission will have a role in determining:

- the services to which access to third parties must be provided; and
- the terms and conditions upon which access is to be provided.

It must be stressed that the legislation envisages a regime of industry self-regulation and commercial determination. A primary mechanism through which services can be 'declared' as access services is through the recommendation of the Telecommunications Access Forum (TAF). Recommendations by the TAF are to be by industry consensus. In addition, it is envisaged that the primary mechanism through which the terms and conditions of access are to be determined is through commercial negotiation.

The Commission does, however, have important functions in both the declaration of access services and in the determination of terms and conditions of access. During the transition to the new regime the Commission has been required to deem certain services (contained in existing access agreements) to be declared. [\[1\]](#) In the long term the Commission can also declare services after holding a public inquiry.

In regard to the terms and conditions of access, the Commission's role can be described as one of a 'safety net'. One of its main functions is to arbitrate disputes if the terms and conditions of access cannot be determined through commercial negotiation or alternative dispute resolution processes.

The aim of this paper is to outline the Commission's approach to its role in access pricing. This involves an outline of the Commission's on-going responsibilities in this area and a brief discussion of its approach to these responsibilities. The discussion draws heavily on the Commission's publication - *Access Pricing Principles - Telecommunications* (July 1997) (the guide).

The Commission's Responsibilities in Access Pricing

Under Part XIC of the Act, the Commission has a role in determining a price for a declared service, or a method for ascertaining a price when undertaking the following tasks:

- approving (or otherwise) the Telecommunications Access Forum (TAF) access code which may include the model terms and conditions for access to declared telecommunications services;
- approving (or otherwise) undertakings submitted by access providers which may include the terms and conditions of access to declared telecommunications services; and
- arbitrating disputes between parties concerning the terms and conditions of access to declared telecommunications services.

The legislation also required the Commission to determine transitional terms and conditions upon which a certain class of service providers connect to Telstra's network. In this determination the Commission reduced usage charges service providers using Telstra's National Access service must pay for originating and terminating calls. These terms and conditions, determined under section 41 the *Telecommunications (Transitional Provisions and Consequential Amendments) Act 1997*, will continue for a six month period until 31 December 1997. [\[2\]](#)

Legislative Criteria

The Commission in meeting its on-going and transitional access pricing responsibilities must ensure that access prices are **reasonable**. In determining whether terms and conditions are reasonable, Part XIC specifies that regard must be had to the following matters:

- whether the terms and conditions promote the long-term interests of end-users of carriage services or of services supplied by means of carriage services;
- 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.
- the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else.

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

The long-term interests of end-users are promoted by achieving the following objectives:

- promoting competition in markets for telecommunications services;

- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users;
- achieving the economically efficient use of, and the economically efficient investment in, telecommunications infrastructure.

The criteria above are interdependent. In some cases promoting one criterion will promote another. In other cases, the criteria are conflicting. For example, telecommunications is an industry where the delivery of many services is characterised by large economies of scale and scope. Therefore, a central dilemma which must be confronted is that an access price that promotes the economically efficient use of infrastructure in the short term may, in some cases, not promote efficient investment in infrastructure in the long term and may not be consistent with the legitimate business interests of the access provider. In particular, an access price based on the direct incremental cost of providing access may not always allow an efficient access provider to recover all its costs.

In addition to promoting the economically efficient use of, and investment in, infrastructure, the access regime established by Part XIC attempts to open up to competition markets which are potentially competitive but where the scope for competition depends on the services of bottleneck facilities. [3] The access price should allow more efficient sources of supply to displace less efficient sources within these potentially competitive markets. However, the access price should also allow vertically-integrated firms to exploit economies of scale and scope to deliver services to end-users at least cost.

Further, access prices and the processes of competition which Part XIC harnesses should encourage suppliers to produce the kinds of services most highly valued by end-users, improve customer choice and product quality, and supply services in the least-cost way.

Commission's Approach to Access Pricing

The Commission's approach to access pricing, as detailed in the guide, can be divided into four parts:

- identifying declared services to which the Access Pricing Principles (APP) should apply;
- broad pricing principles;
- pricing guides which will assist the Commission in assessing undertakings and in arbitrations;
- methodology the Commission will apply when required to determine an access price.

1. Declared services to which the APP should apply

The range of declared services can be broad, including services required to achieve any-to-any connectivity. As a result it may not be appropriate to apply the APP (in particular cost-based pricing) to all declared services.

The Commission will consider whether the pricing principles apply to particular declared services on a case-by-case basis. In general they will apply to declared services:

- that are necessary for competition in dependent markets;
- where the forces of competition, or the threat of competition, work poorly to constrain the price of access to efficient levels; and
- that are well developed in the market.

One example, is the Customer Access Network (CAN) which has a high degree of bottleneck power and is considered to be an essential service for competition. The largest potential gains from regulatory intervention in access pricing are likely to come from cost-based pricing of the above services. Narrowing the range of services also reduces the risk of the loss that may be caused by inappropriate regulation.

2. Broad pricing principles

An access price consistent with the legislative criteria is difficult to determine *ex ante*. The approach adopted by the Commission to guide it when performing its access pricing functions under Part XIC is to consider the constraints that would be placed on the pricing behaviour of access providers if they faced effective competition (given the characteristics of the market). Specifically prices should be consistent with the levels that would occur if the access provider faced the threat of being displaced as a supplier. [4]

This yields four broad principles. These principles aim to assist in redressing any unequal bargaining power inherent in commercial negotiations over access. In usual commercial negotiations there are mutual benefits from trade. However, in negotiations over access small network operators seeking access usually have much to lose in not gaining access. The four pricing principles, that will be used by the Commission in assessing undertakings and in arbitrations, aim to assist in re-balancing any unequal bargaining power.

Access prices should be cost based

The price of a service should not exceed the minimum costs an efficient firm will incur in the long run in providing the service. The relevant costs are the economic costs of providing the service. These are the on-going (or forward-looking) costs of providing the service, including a normal commercial return on efficient investment.

Access prices should not discriminate in a way which reduces efficient competition

An access price should not have the effect of reducing efficient competition. In particular access prices should allow more efficient sources of supply to displace less efficient sources of supply in dependent markets.

This principle does not imply that all access seekers should pay the same access price. Commercially determined prices can differ across buyers for a range of reasons. Demand patterns may generate different prices, as may factors that generate differences in the economic costs of supplying different buyers. [5]

However, differential pricing can reduce efficient competition. Preferential access pricing between a limited group of network operators can have the effect of discouraging entry of more efficient operators. [6] Differential pricing can also discourage investment. In an industry where assets often have little alternative use, there is scope for an access provider to appropriate the commercial returns to the assets of access seekers through high access prices. [7]

There appears to be even greater scope for differential pricing to reduce efficient competition where an access provider provides preferential pricing to its own vertically-integrated operations or to its subsidiaries or associates. The incentive for the access provider to discriminate against competitors can inhibit efficient entry and competition in those markets.

The Commission expects that in most undertakings the same menu of offerings will be available to all access seekers on a non-discriminatory basis. Where an undertaking provides scope for differential pricing not based on costs the Commission must be satisfied that such differential pricing will promote competition and will enhance the efficient use of, and investment in, infrastructure.

As discussed below, when arbitrating disputes the Commission will use a cost-based approach. As such, differences in prices across the Commission's arbitration determinations will be based solely on differences in costs.

Access prices should not be inflated to reduce competition in dependent markets

An access provider facing effective competition will not be able to inflate the access price with the aim of reducing competition in dependent markets.

Access prices should not be predatory

If the forces of competition (or threat of competition) work effectively, an access provider will not be able to successfully predatory price. A predatory price is a price below the incremental cost of production with the aim of reducing competition or discouraging entry into the market (with the objective of pricing above cost once the competition has been removed).

3. Pricing Guides

In reality it is difficult, time consuming and costly to determine whether a price is cost based, discriminates or is inflated to reduce efficient competition, or is predatory. The Commission has developed price guides that involve comparisons between access prices and observable (or potentially observable) prices and are designed to provide parties with some assistance in developing undertakings.

If a price in an undertaking is inconsistent with the guides, it will signal to the Commission that it may be inconsistent with the pricing principles and the legislative criteria under Part XIC, and will need to be examined carefully. These guides may also be used by the Commission in arbitrations to assist in narrowing the range of acceptable price outcomes:

- comparison of an access price and the access provider's internal transfer price for the same or similar service;
- assessment of changes of access prices over time;
- comparison of access prices and retail prices; and
- comparison with other observed access prices.

4. Methodology for Determining a Price

When arbitrating disputes on access prices, and where necessary when approving undertakings, the Commission must be satisfied that the access price is based on the cost of providing the service. Determining a cost-based price involves identifying which costs to include and establishing and verifying the size of these costs.

There are many variants of cost-based pricing depending upon the costs that are included, how they are allocated and how they are measured (particularly common costs and capital costs). [8] The Commission's view is that for the types of services mentioned above, the access price should be based on the total service long-run incremental cost (TSLRIC) of providing the service.

TSLRIC is the incremental or additional costs the firm incurs in the long term in producing the service, assuming all of its other production activities remain unchanged. It is the cost the firm would avoid in the long term if it ceased to provide the service. As such, TSLRIC represents the costs the firm necessarily incurs in producing the service and captures the value of society's resources used in its production.

TSLRIC consists of the operating and maintenance costs the firm incurs in providing the service, as well as a normal commercial return on capital. TSLRIC also includes common costs that are causally related to the access service.

TSLRIC is based on forward-looking costs. These are the on-going costs of providing the service in the future using the most efficient means possible and generally available. In practice this often means basing costs on the best-in-use technology and production practices and valuing inputs using current prices. [9]

Measuring TSLRIC is a difficult and time consuming exercise. Decisions about how to measure and allocate costs can potentially have as large an effect on the access price as the choice of pricing methodology. Details concerning the measurement of costs are included in the guide.

Conclusion

The ACCC intends to make its decision process as thorough and transparent as possible. In an effort to ensure that our access pricing process is thorough, the Commission actively seeks comment from relevant industry participants. To ensure transparency, the Commission makes a point of making its decisions publicly available together with the reasons for these decisions. All ACCC guidelines can be obtained from the ACCC Internet Home Page (www.accc.gov.au) and additional information can be obtained from any ACCC office.

The pricing principles, pricing guides and specific cost-based methodology constitute the general approach the Commission currently intends to take. The Commission's approach to access pricing may not be static. Access pricing (and specifically the pricing of interconnection) in telecommunications is still a developing issue in Australia and overseas.

Finally, I would like to say that the ACCC is looking for continued industry input into this process to ensure it is as effective, efficient and workable as possible.

Footnote 1: For more details see ACCC, *Deeming of Telecommunications Services*, 30 June 1997.

Footnote 2: Or for a longer period as determined by the Commission.

Footnote 3: A bottleneck facility is used to provide services that are essential for firms to supply in downstream markets. A bottleneck facility is usually very costly or impossible to duplicate. As such, there is scope for the owner of a bottleneck facility to reap abnormally high profits through restricting the supply of services from the infrastructure and reducing competition in dependent markets.

Footnote 4: This does not imply that the Commission believes the market for declared services is or should be perfectly competitive. Nor does the Commission expect access prices to replicate the outcomes that would occur if the market was perfectly competitive.

Footnote 5: The costs of supplying different access seekers may vary for a number of reasons including differences in the volume of the service purchased; differences in the duration and/or frequency of access agreements; risk-sharing associated with long-term or fixed volume/capacity agreements; collateral benefits provided by the access seeker (for example through stimulating extra demand for the access provider's network services during periods of, or on routes with idle capacity); and differences in credit worthiness.

Footnote 6: For example, preferential interconnect pricing between two large network operators may prevent smaller operators competing and have the effect of establishing or maintaining a duopoly.

Footnote 7: As the access seeker will need the access service to make these assets productive, there is scope for the access provider of a bottleneck facility to charge high prices for access.

Footnote 8: These variants include directly attributable incremental costs (DAIC), fully distributed costs (FDC), short-run incremental costs (SRIC), long-run incremental costs (LRIC), etc.

Footnote 9: In most cases, using forward looking rather than historic costs will result in the more efficient use of, and investment in, infrastructure. Historic costs guarantee a normal commercial return to the access provider independent of the quality of its

investment decisions. Cost valuation based on the best-in-use technology (rather than historical costs) provides stronger incentives for appropriate investment decisions through rewarding/penalising the access provider for good/poor investment decisions. Using historic costs also increases the scope for access providers to shift costs from competitive segments of the market to less competitive segments. This can deter entry and inhibit competition in dependent telecommunications markets. Finally, efficient 'build or buy' decisions will be based on whether a firm can provide the service at a lower cost using the best-in-use technology. As historic costs may not represent costs using the best-in-use technology, access prices based on these costs may result in inefficient 'build or buy' decisions.