Indicative prices for wholesale line rental and local call services

A REPORT PREPARED FOR THE COMPETITIVE CARRIERS COALITION

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Executive summary

The Australian Competition and Consumer Commission (ACCC) has recently issued draft indicative prices for wholesale local call (LCS) and wholesale line rental (WLR) services.

This has followed its final declaration decision in its Local Services Review (July 2006), in which the ACCC has re-declared the LCS and declared WLR for the first time.

The draft indicative prices follow a 'retail minus retail cost' methodology. Telstra's retail prices for local services are reduced by avoidable retail costs to derive the access price. The ACCC has proposed prices of 17.69 cents per local call and $23.57 and $26.30 for residential and business line rental respectively.

The Competitive Carriers Coalition has asked Frontier Economics to review two aspects of the ACCC's draft indicative prices:

- the choice of 'unbundled' retail prices in setting access prices, and
- the ACCC's application of Telstra's methodology to estimate retail costs.

To review these aspects of the decision, we have examined the rationale for the use of 'unbundled' retail prices and the potential for detriment to competition and efficiency (and hence, the long-term interests of end users (LTIE). We then examined the robustness of the methodology employed to estimate retail costs.

Our conclusions are as follows:

- the use of unbundled retail starting prices in the retail minus methodology has provided Telstra with incentives to price its retail services in a manner inconsistent with the promotion of the LTIE. In the event that the methodology remains in place for a number of years (which appears possible, given the likely time taken to develop an appropriate fixed services cost model), we foresee a continuation of pricing distortions and continuing problems for access seekers in providing an effective competitive constraint on Telstra in fixed voice services and other markets.

  We also find that the problems associated with alternative starting prices seem overstated. In particular, an approach which simply took the average of the all retail local service prices would provide appropriate incentives for competition to focus on areas where price-cost margins and demand elasticities are highest – consistent with (efficiency enhancing) Ramsey pricing principles.

- The ACCC uses the appropriate principle in identifying relevant retail costs. However, in its application of the principle, the ACCC has not made certain adjustments to Telstra's data which have in the past been made, and, without contrary evidence, should continue to be made. We consider that results in an understatement of avoidable retail costs – by our preliminary estimates by around 1.3 cents per local call and $1.12 per line per month (see Table 3).

1 Introduction

1.1 DEVELOPING INDICATIVE PRICES

The Australian Competition and Consumer Commission (ACCC) has recently issued draft indicative prices for wholesale local call (LCS) and wholesale line rental (WLR) services.

This has followed its final declaration decision in its Local Services Review (July 2006), in which the ACCC has re-declared the LCS and declared WLR for the first time.

Under Section 152AQA of the Trade Practices Act 1974 (TPA), the ACCC must determine pricing principles for a declared service. In section 10.6 of its July 2006 report, the ACCC stated that it would continue to use a 'retail minus retail cost' (RMRC) pricing approach for the LCS and WLR services for an interim period, but would seek to implement a cost-based pricing approach once a robust cost model becomes available.

The TPA also states that a pricing principles determination may contain price-related terms and conditions. This allows the ACCC to specify a price or prices when it makes a pricing principles determination, although the prices will be indicative only.

The ACCC decided that it was appropriate to determine indicative prices that would apply for the LCS and WLR under the interim RMRC pricing principle that will be used to price the services in the next year.

The ACCC's methodology in deriving the draft indicative prices was broadly as follows:

- Start with the retail prices for Telstra's HomeLine Part and BusinessLine Part services, which are purchased by retail customers who pre-select other carriers for fixed-to-mobile and long distance calls;
- Derive average avoidable retail costs for WLR and LCS services from Telstra's RAF data for 2004-05, using a methodology proposed by Telstra in its PSTN OTA and LCS Undertakings;
- Unitise those costs by the number of retail lines and number of retail local calls made by Telstra customers, and deduct the relevant unit cost from the retail price of LCS and WLR services; and
- Adjust the LCS price to reflect the proportion of GST that should be allocated to access seekers.

These draft indicative access prices are summarised below.

	Residential	Business
WLR	$23.57 per month	$26.30 per month
LCS	17.69c per call	17.69c per call

Table 1: Draft indicative prices for WLR and LCS (all ex GST)

Source: ACCC

The ACCC has noted the short-term nature of these interim prices:

> "These interim prices would apply while the ACCC finalises its assessment of Telstra's undertakings for the PSTN OTA and LCS…(p.79)
>
> 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" (p. 80)

Although not directly relevant to the work we have undertaken, we also note the ACCC's reference to Telstra's PSTN and LCS undertakings lodged in March 2006. Acceptance of these undertakings will override any indicative prices. In its undertakings, Telstra proposed a significant reduction in LCS prices (to 9.28 cents per call). This undertaking is based on the application of an RMRC pricing principle, where the starting point is Telstra's unbundled local call price of 22 cents per call. Retail costs associated with the provision of both local calls and line rental are deducted from this – that is, there is no independent retail minus pricing of line rental and local calls. When calculated on an independent basis, the ACCC's indicative prices are the same as those proposed in the Telstra undertaking.[1]

1.2 THE APPLICATION OF 'RETAIL MINUS' PRICING

In issuing indicative prices, ACCC has sought comment on the draft indicative prices and the approach taken by the ACCC to calculate them. However, it has also indicated that comments should be limited to the application of that principle, not the principle itself.

The Competitive Carriers Coalition (CCC) has asked Frontier to consider whether the ACCC's application of the 'retail minus' methodology for local services is likely to promote the long-term interests of end-users (LTIE).

In particular, the CCC has asked Frontier to undertake further analysis of:

- the use of 'unbundled' retail prices in setting access prices, and
- whether the ACCC's application of Telstra's methodology is a robust method of estimating avoidable retail costs.

[1] That is, the 20 cents (ex GST) price less 2.54 cents of retail cost avoided from local calls is 17.69 cents, while the additional 8.41 cents per call of retail cost derived from line rental (equivalent to $5.47 per line, per month) takes the price to 9.28 cents per call.

2 Use of an unbundled starting price

2.1 CURRENT APPROACH AND PROBLEMS

A key issue that has been in contention since the initial development of the retail minus pricing approach has been to identify the appropriate starting price from which relevant retail costs are deducted.

The ACCC's view, which is supported by Telstra, is that it is appropriate to use Telstra's 'unbundled' retail local call service offerings as a basis for subtracting retail costs to determine suitable wholesale local service prices. The 'unbundled' offerings refer to independent purchase of the local services, with other pre-selected calls being supplied by a third party access seeker.

In general, access seekers have not been supportive of the ACCC's methodology. The basic problem with the methodology is that, given current consumption patterns, it provides Telstra with an incentive to marginalise its retail customers that do not bundle and, by extension, marginalise its access seeker competitors. The weakness in the methodology is apparent in that:

- only a small number of Telstra's customers take unbundled local services, undermining the credibility of the unbundled price as an appropriate regulatory benchmark; and
- there is a negative margin between wholesale and retail local services prices, indicating that Telstra has exploited the methodological weakness.

2.1.1 Small number of customers take unbundled local services

Only a small proportion of Telstra's retail customers – the CCC estimates fewer than 5 per cent – actually purchase unbundled local services. This creates a disconnection between the access price and observed consumer behaviour in the markets in which local and pre-selected services are supplied. It creates an incentive for Telstra to raise unbundled prices to the maximum allowable – knowing that they will only affect a small proportion of its customers (who can always switch to Telstra's bundled services), but hurt the majority of its competitors who seek to bundle local services with pre-selected services.

The weakness in linking to unbundled prices can be seen by thinking about what would happen if no consumers took up unbundled local services – would it still then be appropriate to use these as the starting price for a retail minus methodology? In our view, the answer must be no as the price set would be arbitrary, and it would suggest an obvious defect in the regulation – but that is not very different from the current situation. While it is true that Telstra is constrained by retail price controls from further increasing unbundled prices, the current methodology has provided strong incentives for Telstra to price downstream competitors out of the market by choosing unbundled retail prices that are extremely unattractive in comparison to its bundled local services prices.

2.1.2 Retail and wholesale price differences

Over time, Telstra has increasingly taken advantage of its pricing freedom by narrowing the gap between access prices and retail prices, and more recently has created a negative margin (even without the inclusion of retail costs).

This can be illustrated with reference to Telstra's latest results (full-year to June 2006). Over that period, Telstra recovered $333 per line for retail lines, and $336 for wholesale lines. This compares with the previous year where the comparison was $338 for retail and $307 for wholesale. So at a time when retail line rentals have been falling in price, wholesale prices have actually been rising substantially.

The pricing freedom and the use of this freedom to create increasingly negative margins for local services limits the intensity of competition in two ways:

- By pushing up wholesale local services prices and thereby making the acquisition of new customers less profitable, Telstra is able to 'soften' competition between itself and competitors. The intuition behind this effect is straightforward. The higher is the cost to Telstra's competitors associated with each customer, the higher is the price needed for the competitors to recover their costs. Rises in wholesale line rental prices will cause all firms – including Telstra – to be less likely to aggressively reduce prices to compete for customers or look for other ways to lure away marginal customers.[2]

  In addition to the ability to raise wholesale prices, Telstra's ability to manipulate its retail and wholesale local services prices allows it to capture the rents associated with pre-selectable calls – when those rents might otherwise facilitate more aggressive competition by access seekers. Telstra has achieved that result by pricing its unbundled retail local services (and consequently, wholesale local services) at a high price, while making the focus of price competition its bundled local services. That means that competitors are not able to compete by reducing the price of pre-selectable calls, as they must use the available profits to cross-subsidise loss-making local services.

- The negative retail margins on local services create an (asymmetric) risk for access seekers that is not faced by Telstra. If the access seeker's customers do not make a sufficient number of profitable calls to offset the negative retail margin plus the access seeker's retail costs, the access seeker faces a real financial loss. However, Telstra's risk of real losses is negligible, as although access seekers face an access price that recovers long run average incremental costs (plus a likely contribution to common costs), Telstra actually only incurs the short-run marginal costs of additional local services. That means that customers create profit for Telstra even where few calls are made. We note that the Commission has issued a competition notice alleging a form of

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[2] The proposition that competition will be affected by actions that reduce the incentives of firms to compete for marginal customers comes from the standard models by which economists analyse strategic interactions among enterprises. In a model of Bertrand (price) competition with differentiated products, it is straightforward to show that Telstra's actions in increasing prices to downstream competitors will not only mean that competitors' charge higher prices, but that it will also be optimal for Telstra to raise prices. See, for example, the analysis in David Besanko, David Dranove and Mark Shanley, *Economics of Strategy*, 2nd edition, John Wiley, 2000, pp 268-81

this behaviour (alleging a price squeeze on low spend customers). In contrast to previous considerations that have found Telstra's behaviour to be largely innocuous (e.g. in 2003), this creates an impression that the current setting of wholesale prices has 'failed' to promote competition – not only in the fixed voice market/s, but in markets for broadband and other emerging services. As access seekers look to use resold local services as a 'stepping stone' towards infrastructure investment (using Telstra's unbundled local loops), conduct that increases the cost of acquiring fixed voice retail customers can also limit investment and therefore the emergence of more sustainable competition in broadband markets (e.g. using ADSL for internet access) and associated markets (e.g. using VoIP, IPTV).

There are also good reasons to believe that the pricing structure facilitated by the implementation of the retail minus approach is inimical to allocative efficiency. We consider that application of the well-known Ramsey pricing principles to fixed voice services would tend to support a retail pricing structure which looks quite different to what we currently see in the market.

Ramsey pricing principles are generally applicable where firms incur fixed or common costs across services or customers, and must therefore 'mark up' the individual prices of services above marginal or incremental cost to recover those costs in aggregate. These mark-ups cause efficiency losses, but the efficiency losses from these mark-ups can be minimised in two ways – by recovering more of these common costs from services with a lower (absolute) demand elasticity, and by spreading the cost recovery over as many services as possible (this is because the efficiency loss is greater the higher is the price-cost margin on a particular service).

Compared to current market outcomes, these principles would tend to suggest that a move towards higher line rental charges and lower usage charges would increase economic efficiency. We say this because this because the current structure involves little recovery of common cost from services with a lower price elasticity (local services) and quite a lot of recovery from services which are more price elastic (pre-selectable calls). Consequently, there are likely to be efficiency gains from lowering price-cost margins in pre-selectable calls (which currently appear to be quite high – the margin of price over average cost for these calls is estimated to be around 50 per cent, according to Telstra's Imputation RKR reports)[3], and raising margins in local services (which, at least according to Telstra, are priced close to or below incremental cost).

While we recognise that (a) network externalities, and (b), increasing mobile competition, might favour lower local services prices, we see little persuasive evidence that the current pricing structure is likely to promote efficiency in use. In that case, the use of unbundled prices appears to hinder competition with little 'payoff' in terms of efficiency gains.

[3] See e.g. the October-December 2005 report, available at www.accc.gov.au.

Use of an unbundled starting price

2.2 A 'RATCHET' PROBLEM?

The common criticism levied at alternatives to the use of unbundled retail local services is that they create a 'ratchet' problem. Telstra has expressed this as follows:

> "The unbundled local call price is the appropriate starting price for the RMRC calculation because it allows Telstra to respond to competitors by lowering its bundled prices, without these changes flowing through to wholesale prices. In effect, this is the only way that Telstra is able to compete for the full bundle of PSTN services without creating a spiralling effect of ever declining wholesale and retail prices for local calls—which would obviously severely compromise the funding of the network."[4]

Telstra is not directly limited in its ability to reduce any of its service prices within its retail bundles. However, Telstra argues that adoption of a RMRC methodology that incorporated Telstra's bundled local service offerings would create a strong disincentive for it to actually reduce retail local service prices in response to competitor offerings. That is because such reductions would immediately flow through to competitors as lower local service access prices. (It would not affect Telstra's incentives to cut prices for pre-select calls.)

We do not argue that a change towards approaches that use bundled retail local services prices would not change Telstra's incentive to lower retail local services prices in response to lower competitor prices.[5] Nevertheless, we believe that the relevant question for the ACCC is whether that would create greater competitive detriment than that which results from the current application of RMRC, which appears to both hinder competition and be inconsistent with efficient use of infrastructure. As we note above, the current application of the retail minus approach creates incentives for pricing structures that are the opposite of those that might be seen in an efficient Ramsey-pricing structure.

By using starting retail price alternatives that are more reflective of Telstra's actual average prices for local services, Telstra's ability to disadvantage its downstream competitors by keeping unbundled retail (and hence wholesale) prices high is limited. We would expect that competition should therefore drive Telstra to adopt a more rational and efficient pricing structure for its bundled services, with higher local services prices and lower call charges for long distance and fixed-to-mobile calls, and that that would be in the LTIE.

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4 Telstra's Submission in Support of its Undertakings Dated 22 March 2006, paragraph 98

5 We also note that if undercutting Telstra on local services prices was considered to be a significant competitive problem, a better way to address that concern would be to allow Telstra to use a pricing structure which prevented that (e.g. by allowing Telstra to charge a higher access price if undercut). That would encourage Telstra to set an efficient retail price structure without disadvantaging access seekers. The introduction of capped retail plans may reduce the usefulness of that solution, however.

2.3 ALTERNATIVE APPROACHES

As illustrated above, we consider that the current unbundled pricing approach has created market distortions that are not in the LTIE. We have also noted that the use of alternatives are unlikely to create a 'ratchet' problem with welfare-diminishing effects. Having said that, a viable alternative to the unbundled approach must not only avoid the problems alluded to in section 2.1., but also not create other undesirable consequences. That is not the same as saying that alternative approaches will not change price-setting incentives – after all, that is the point of the change – but that incentives should become more aligned with normal competitive constraints.

- **Apply 'retail minus' to the entire bundle, or to each individual service**

Under this approach, one would provide for average retail costs to be deducted from average retail revenues across a bundle of fixed voice services. Alternatively, one could provide for retail costs to be deducted individually from the average retail price of each service in a fixed voice bundle.

Both of these approaches have the advantage of avoiding the problems described earlier. There would be no incentive to selectively increase prices of particular services, and the access prices would clearly better reflect actual retail market behaviour. However, both of these approaches create a problem, in that if they only remove retail costs, they would require the extension of access regulation to wholesale services that are not currently regulated.[6] By this we mean that there is no 'wholesale long distance' declared service which would be the wholesale equivalent of LCS or WLR. Cost-based access regulation of PSTN OTA services is sufficient to facilitate competition in long distance services and it would seem to be a retrograde step to require Telstra to give access to such a service. Hence, even putting to one side potentially complicated implementation issues, it appears that this approach may have undesirable consequences from the ACCC's point of view.

- **Apply 'retail minus' to an average of local services packages (including bundles)**

Under this approach, the retail costs would be deducted from the weighted-average retail price of Telstra's local service packages, regardless of whether or not those prices are offered as part of a bundle.

It is clear that this approach would discourage Telstra from opening a wedge between unbundled and bundled retail prices. We do not see this as a negative consequence as we do not consider that such a wedge can be justified on economic efficiency grounds.

We illustrate this methodology below with reference to an example that broadly reflects current price trends – two types of local services bundles (one higher

[6] Alternatively, if the methodology was implemented with reference to retail costs for local services, and retail costs plus other network costs for PSTN OTA services, this would require considerably more work to implement in the short term.

fixed price and lower call price, one the opposite) and one unbundled service (which has generally higher prices).[7] Under these assumptions we can see that the weighted average access price would be $23 for line rental and 20 cents for calls (also assuming retail costs are zero).

	Line rental	Local calls	% of customers
"High spend" bundle	$25	15 c	50%
"Low spend" bundle	$20	25 c	45%
Unbundled	$30	20 c	5%
Access price – bundle	$23	20 c	

Table 2: Example - access prices based on illustrative weighted average retail prices

Suppose further that the LRICs of WLR and LCS are $25 and 20 cents per call, so that (as Telstra claim) the illustrative access prices would not be recovering costs. In these circumstances, Telstra will face an (appropriate) incentive to push up its retail local services prices so that access prices at least recover cost. Retail competition will therefore focus much more on reducing call prices closer to cost (with associated allocative efficiency gains). By contrast, the current approach provides incentive for Telstra to *push down* bundled local services prices as long as it can avoid a price squeeze across all of its bundled fixed voice services. This approach does not provide incentives for retail prices to reflect efficient cost recovery principles, which are associated with lower mark-ups on those services which have (more) elastic demand – and we are unaware of any studies which suggest that line rental and local calls would have more elastic demands than those for pre-select calls.

2.4 CONCLUSIONS

Frontier considers that the past use of unbundled retail starting prices in the retail minus methodology has provided Telstra with incentives to price its retail services in a manner inconsistent with the promotion of the LTIE. In the event that the methodology remains in place for a number of years (which appears possible, given the likely time taken to develop an appropriate fixed services cost model), we foresee a continuation of pricing distortions and continuing problems for access seekers in providing an effective competitive constraint on Telstra.

We also find that the problems associated with alternative starting prices seem overstated. In particular, an approach which simply took the average of the all retail local service prices would provide appropriate incentives for competition to focus on areas where price-cost margins and demand elasticities are highest – consistent with (efficiency enhancing) Ramsey pricing principles.

7 This obviously ignores complications associated with Telstra's introduction of single-price bundles (Homeline Ultimate, Homeline Together), but these products seem unlikely to take a major share of Telstra's fixed voice portfolio in the short term.

3 Methodology for calculating retail costs

In this section of the report, we examine the principle behind the calculation of retail cost for use in a retail minus access pricing methodology. We then look at the adjustments made by the ACCC in the 2003 model prices determination, and consider whether similar adjustments should be made to determine indicative prices for 2006-07.

3.1 PRINCIPLE

The ACCC has expressed the principle behind the calculation of a retail minus approach in various ways. It has previously debated whether the retail minus calculation should leave Telstra indifferent between whether it retails or wholesales local calls (and line rental).[8]

In our view, the better interpretation of a retail minus access pricing rule is that its general efficiency claims are based on providing correct incentives for efficient entry, while minimising pressure on the access provider to adjust its retail tariffs.[9] This second point is commonly levied as a criticism of the retail minus approach[10], but it can in fact be a strength where there are factors which prevent or reduce the need for direct implementation of a cost-based approach (e.g. to maintain cross-subsidies, or when end prices are already regulated).

Taking that interpretation, the retail minus approach will facilitate efficient entry wherever an access seeker's incremental costs of entry are lower than Telstra's avoidable costs of retailing. That implies that it would be more relevant to calculate the retail costs that Telstra would be able to avoid in the longer run. Any other approach (e.g. costs actually avoided in the short run) would result in access seekers only entering if their incremental costs were low enough to offset Telstra's cost advantage in having entered first. While that may present short-term efficiency advantages, that is unlikely to be in the long-term interests of users, as it discourages entry of more efficient competitors.

This can be illustrated via a simple example. Consider a case where Telstra's retail costs consisted of $5 of fixed (but not sunk) cost and $10 of variable cost. Its long run avoidable costs would then be $15. Suppose that an entrant's incremental retailing costs were $12 – in that event, using an 'avoided' cost standard (ignoring the costs that are fixed) would dissuade this entrant from entering even though they are a more efficient supplier of the retail services.

We note that the ACCC has also concluded that an avoidability standard is more relevant to its calculation, and that although this has previously been an issue of dispute, there now appears to be widespread support for the use of such a standard.

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[8] See e.g. ACCC, *LCS pricing principles and indicative prices*, July 2002, p.21.

[9] See, for example, Armstrong, M., "The Theory of Access Pricing and Interconnection", in Cave et al, *Handbook of Telecommunications Economics,* Vol. 1, p. 316.

[10] Or the efficient component pricing rule (ECPR), as the retail minus rule is an application of this rule.

3.2 ISSUES IN THE APPLICATION OF PRINCIPLE

The ACCC was initially required to apply the 'retail minus retail costs' (RMRC) principle in 2001 in response to a large number of arbitrations. We understand that consultants NERA were engaged to determine Telstra's average retail costs.

The process of determining average retail costs involved interpretation and analysis of Telstra's RAF data. We also understand Telstra prepared a cost study at that time.[11] Unfortunately, neither of these studies is publicly available. This has limited our ability to critically review the arguments put forward in those studies.

From the ACCC's 2003 model prices determination, we understand that NERA made certain adjustments to the RAF data to ensure it accurately reflected retail costs. This included:

- Removing certain unambiguous wholesale costs;
- scaling up retail costs for line rental and local call services, because the original allocations looked too low;
- Including part of IT costs and all of marketing costs as avoidable;
- addition of capital financing costs that would become avoidable if the provider was wholesale only; and
- adding a reduction in Telstra's USO contribution as it would no longer have eligible retail revenues.

The ACCC made a further adjustment to account for the fact that Telstra was required to accommodate the GST by the Government when it was introduced in 2000.

In the 2006 Local Services Review, the ACCC states that:

> "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. 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." (p81)

and

> "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. 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." (p82)

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[11] ACCC, *op.cit.*, p. 29.

In Telstra's submission in support of that undertaking (22 March 2006), it notes the following about its retail cost methodology:

> "99. To calculate the retail costs that should be deducted from the retail starting price, Telstra uses the 2004/05 Historic Regulatory Accounting Framework ("RAF"), the most recently available audited accounts. Telstra calculated these costs as average retail costs, consistent with the Commission's previous views on the appropriate methodology. Telstra has deducted the retail costs associated with both local calls and basic access, consistent with the methodology used previously."

Telstra further notes that:

> "100…The retail costs in the RAF are comprised of organisational, product and customer and cost of capital costs. The only adjustment made to these costs is to remove installation costs (line item 4-2-01) from the product and customer costs. "

There appears to be a degree of inconsistency in these statements. It is unclear how Telstra can claim to be following a methodology used previously where it later states it only makes a single adjustment to remove installation costs. In contrast, the ACCC notes that a number of adjustments that were made previously were not made in calculating the indicative prices.

It is not wholly clear to us which adjustments Telstra made and which it did not. Our approach in the following sections of the report is therefore to comment on the appropriateness of adjustments to retail costs that were made by NERA in 2001 and by the ACCC in 2003, and on whether the ACCC should make similar adjustments in setting indicative prices from 2006 on.

3.2.1 Scaling up of retail allocations

The 'scaling up' of retail cost allocations was first raised as an issue by NERA in its report to the ACCC. We understand that the approach taken was to scale up the share of certain retail costs allocated to local services to a level that was 30 per cent below the average allocation for all other RAF services.

The rationale for making such adjustments has not been explicitly stated by the ACCC, nor has the NERA report been publicly released. We would expect that it is in response to a perceived 'under allocation' of retail costs towards retail local local services; however, without a more detailed rationale it is difficult to comment on the appropriateness or otherwise of such adjustments.

In making the adjustments proposed by NERA in 2003, the ACCC stated that:

> "This matter formed a part of n/e/r/a's original retail cost considerations. In that context it noted there may be some merit in Telstra's argument for why basic access and local calls may not have retail costs as high as other services. As outlined above this is because adjustments need to be made for the level of network and other wholesale costs incurred by Telstra in supplying basic access and local calls services. On this basis n/e/r/a's recommended approach involved scaling up only be applied where cost categories for basic access and local calls have an allocation to retail that is 30 per cent lower than the average for all other products. Further, that each cost category so affected only be scaled up such that the proportion of retail costs is increased to 30 per cent less than the average for all other products. **The Commission continues to accept this approach which is considered to be conservative and recognise Telstra's concerns** (emphasis added)."

Further, in accepting Telstra's LCS undertaking (December 2004), the ACCC noted that:

> "Optus has submitted that Telstra is able to manipulate its RAF entries to generate a lower level of retail costs. The Commission believes that the issue was dealt with comprehensively at the time of the model price determination and reiterates that it believes that efficient retail costs are as they were determined at that time." (p. 53)

Notwithstanding the conservative nature of the adjustment, it is apparent that it makes a significant difference to the calculated retail cost. The data presented in 2003 indicate that the adjustment increased allocations to local calls and line rental by around $80 million. Similar adjustments in more recent years would equate to around $0.53 per line per month, and 0.5 cents per call.[12]

For these reasons, it would not be appropriate to ignore the issue of scaling up retail costs in setting indicative prices for 2006-07. In particular, it would not be consistent to determine that the 'conservative' adjustments made in 2001 and 2003 are not appropriate now, given that the methodology for determining efficient retail costs was set in 2003 and there has been no underlying change in RAF allocations.

3.2.2 Avoidable IT retail costs and marketing costs

The ACCC notes in the 2003 model prices determination that adjustments were made to retail RAF data to reflect that 19 per cent of IT retail costs are considered to be avoidable, and that all marketing costs are avoidable.

It is unclear whether similar adjustments have been made by Telstra or the ACCC in setting indicative prices. Again, however, it would not be consistent with earlier statements to ignore these adjustments, as they are the best available estimate of avoidable cost.

3.2.3 Capital financing costs

NERA has argued that an adjustment should be made to retail capital financing costs because the wholesaling of local services requires the firm to use less working capital than does the retailing of local services. This presumably reflects different payment terms between customer types – in particular, that the 30 day terms extended to access seekers were less than the terms extended to retail customers.[13] This investment of less working capital of course means that less return is required on that capital.

While there was some debate in 2003 about whether such an adjustment was necessary, Telstra was unable to adduce any evidence to demonstrate that NERA's analysis was incorrect. The Commission's conclusions on the matter were as follows:

> "…Telstra has not supplied any evidence that would convince it that NERA's approach to, and assumptions behind, determining avoidable capital financing costs is incorrect.

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[12] Based on ACCC market indicator data on lines and local call volumes for 2004-05.

[13] ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, p. 99

> For this reason, the Commission does not, at this stage, intend to modify its approach." (p. 99)

One would then reasonably conclude that the only reasonable explanation for not making such an adjustment would be that Telstra has supplied further evidence to contradict NERA's analysis. As such analysis is not referred to by Telstra in its submission on its undertaking, we believe that these capital financing adjustments should continue to be made until the issue is reviewed further.

3.2.4 Reduction in USO contribution

The reduction in USO contribution reflects the view that under the USO arrangements, carriers pay a proportion of their total 'eligible revenue' towards the cost of providing the USO. In simple terms, eligible revenue is calculated as the gross sales revenue of the carrier less a series of revenue and expense deductions.

The requirement to contribute to the USO clearly increases the marginal cost of retailing calls, and is therefore avoidable if fewer retail calls are supplied. Another way to see that is to note that Telstra's contribution to the USO will fall as access seekers resell local calls. Telstra's contribution is merely its percentage of total eligible revenue and, by definition, an increase in an access seeker's revenue must increase the access seeker's contribution and decrease Telstra's. As such it is clear that this should be deducted as a relevant avoidable cost.

A rough calculation suggests that to fund the USO for 2006-07 of $157.7 million, around 0.6 cents from every dollar of eligible revenue is deducted.[14] This equates to around 0.15 cents for every local call, or 20 cents per line per month.

3.2.5 Unitisation of costs

Once the total pool of relevant retail costs is determined from Telstra's RAF, these costs must be unitised by the number of calls / lines.

To be consistent with the cost avoidability principle, it seems reasonably obvious that the retail costs should be divided by the number of calls / lines that Telstra currently retails. Any other approach (say all wholesale and retail calls / lines) would create an arbitrary and odd mix of retail and wholesale cost concepts, and could not be an accurate reflection of the costs Telstra would avoid in the longer-run.

This seems to be the approach that Telstra has taken in determining its recent LCS undertaking:

> "101. The total retail costs are divided by the volume of retail local calls from Schedule 8 of the RAF to convert the retail costs to a cost per call." (p. 31)

However, the ACCC has in the past used 'midpoint estimates' of Telstra's retail and total line and local call services, recognising that there are some costs of

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[14] Based on the 2004-05 assessment, see www.acma.gov.au

retailing that Telstra may be unable to avoid. This seems plainly at odds with the principle discussed above and applied by the ACCC in relation to other costs; i.e. that if you do not use avoidable costs, efficient access seekers are effectively paying for Telstra's fixed retail costs, and will be deterred from entering or competing for local service customers.

We therefore recommend that the ACCC should unitise Telstra's retail costs across Telstra's retail calls and lines.

3.2.6 GST adjustment

We note that while Telstra appears to have ignored certain elements of the Commission's preferred methodology for calculating retail costs, it has included a 'GST adjustment' as being consistent with the methodology.

As far as we understand it, this adjustment reflects the fact that Telstra is limited under the retail price controls from raising local call prices above 22 cents (including GST), which is the same price that was in place in 2000 when the GST was introduced. Telstra was therefore forced to 'absorb the GST'.

In principle, the need for this adjustment is not clear. As we note above, one of the advantages of a retail minus pricing approach is that it allows for retail pricing structures to be maintained even where prices are not aligned with cost (and this was a clear reason for introducing retail minus in the first place). Consequently, it is difficult to understand why the relevant calculation is not to just take the starting retail price (22 cents), remove the GST from that (2 cents) and then deduct the GST exclusive retail costs. Access seekers reselling these calls then apply the GST to their own retail prices.

As was noted in the principles section above, the issue of whether the resulting access price is above or below cost is a secondary consideration to whether the access price is 'competitively neutral' and promotes efficient entry and therefore the LTIE. We therefore consider these adjustments are unnecessary and will in fact discourage efficient call supply by access seekers – essentially, access seekers are compensating Telstra for the fact that Government decided to limit Telstra's ability to raise prices. This does not appear to be any different from arguing that access seekers should be forced to pay more where retail minus access prices do not recover cost. The GST adjustment is simply not an appropriate application of a retail minus methodology.

3.2.7 Allocation of costs between residential and business use

A further issue that arises from the RAF calculations is that there is no split between costs that are attributable to residential and business use, although retail prices do obviously reflect this distinction. This is then reflected in the calculation of the access prices – whereby the same unit retail cost ($5.47 per month or 2.54 cents per call) is deducted from the starting (unbundled) retail prices of $29.05 / 20c and $31.77 / 20c for residential and business services respectively.

One would expect that the retail costs incurred in serving business users should be higher that those incurred in serving residential users. For some costs, for

example customer service costs, we would expect that business customers probably demand and receive higher (and more expensive) levels of service. Business customers also probably have higher bad debt costs on a per line basis, as average defaults will be of higher value. Having said that, the quantum of the difference is unclear (e.g. average defaults might be higher for business users, but less frequent), and some costs will probably be no different – for example, the cost of sending out a bill is relatively fixed. Ultimately, this issue can only be resolved with reference to either (a) further granularity in Telstra's general ledger accounts (if that exists) or (b) a cost study.

3.3 CONCLUSIONS

We draw the following conclusions from our analysis in this section:

- the appropriate principle for calculating retail costs is whether those costs would be avoidable if Telstra ceased providing retail local services;
- unless further evidence is adduced to the contrary, the adjustments for retail cost allocations, capital financing costs and other costs remain relevant to the determination of avoidable cost;
- a USO contribution should be deducted as a relevant retail cost;
- costs should be unitised across Telstra's retail volumes, not combinations of wholesale and retail volumes; and
- the ACCC should re-visit the issue of the allocation of GST to access prices, as the current approach is unnecessary and inconsistent with the basic principle of retail minus.

Taking the approach recommended in this report, we have derived an estimate as to the appropriate indicative prices for 2006/07. Beginning with the current indicative price, our suggested adjustments are as follows (based on residential prices).

Table 3: Possible adjustments to proposed rates

	LCS	WLR
ACCC proposal	**17.69c per call** (=20c – 2.54c + 0.23c)	**$23.57 per month** (=$29.05-$5.48)
Less capital financing (1)	0.46 cents	40 cents
Less retail cost re-allocation (2)	0.48 cents	53 cents
Less USO adjustment (3)	0.13 cents	19 cents
Less GST adjustment (4)	0.23 cents	-
Final estimated RMRC price	**16.39 cents**	**$22.45**

Sources: (1) Calculated using the retail costs reported in the ACCC's 2003 Model prices report (using 2001-02 RAF costs) divided by Telstra lines and calls reported in the ACCC's market indicator data for 2004-05

(2) Calculated using the retail costs reported in the ACCC's 2003 Model prices report (using 2001-02 RAF costs) divided by Telstra lines and calls reported in the ACCC's market indicator data for 2004-05

(3) Using ACMA data on USO contributions and funding. The USO estimate is for 2006-07 ($157m), while the eligible revenue is an estimate using an uplift on 2004-05 returns. This approach leads to considerably higher estimates than using the figures reported under Telstra's 2001-02 RAF data.

(4) Telstra's PSTN and LCS Undertaking, 2006

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