

**Optus Submission to
Australian Competition and Consumer Commission
on
The ACCC Draft Decision on Telstra's
PSTN OTA and LCS Undertaking**

October 2006

Public version

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1. Executive Summary

- 1.1 This submission sets out Optus' comments on the ACCC's draft decision on Telstra's PSTN OTA and LCS undertakings.
- 1.2 Optus supports the ACCC's draft decision to reject Telstra's undertakings which clearly propose prices that are well above cost. Optus submits that Telstra has fallen well short of the requirement to "affirmatively prove" that its undertakings are reasonable.

2. Network costs

- 2.1 The ACCC has expressed strong reservations with Telstra's PIE II model. Since Telstra's network costs are based on the output from the PIE II model, the ACCC has rightly noted that these costs cannot be considered reasonable since they;
- (a) Are unlikely to promote the LTIE;
 - (b) Will result in Telstra recovering more than cost; and
 - (c) Will limit access seekers ability to compete.
- 2.2 Optus shares these concerns and reiterates its long-held view that Telstra's costs estimates are not reasonable and should not be used for the purpose of setting access prices. It is appropriate for the ACCC to reject the undertaking, based as it is on Telstra's PIE II model.

PIE II model

- 2.3 Optus notes that the ACCC's draft decision identifies a number of fundamental concerns with Telstra's PIE II Model.
- 2.4 This is consistent with Optus' own analysis of PIE II as outlined in its submission to the draft discussion paper. It is worth noting that there are now at least 3 independent expert reports on PIE II; n/e/r/a for Optus; Marsden Jacobs and Associates for the CCC; and Analysys for the ACCC. In contrast to the report of Telstra's expert, Bridger Mitchell, each of these reports is highly critical of the PIE II model and cautions the ACCC against relying on output from PIE II for setting access prices.
- 2.5 The table below provides a summary of the views expressed in these independent expert reports on key modelling assumptions used in the PIE II Model.

Modelling assumptions	n/e/r/a/	MJA	Analysys
Network Provisioning	<ul style="list-style-type: none">• Over estimated.• Inappropriately seeks to recover costs associated with anticipated demand.	<ul style="list-style-type: none">• Over estimated.	<ul style="list-style-type: none">• Model unnecessarily overstates demand for some equipment resulting in higher charges
Operating and Maintenance Factors	<ul style="list-style-type: none">• Significant risk that O&M factors are inefficient.	<ul style="list-style-type: none">• Over states direct and indirect O&M factors.	<ul style="list-style-type: none">• Significant risk of overstatement of O&M especially for long lived assets
Network Planning Costs	<ul style="list-style-type: none">• Should not be included as likely to	<ul style="list-style-type: none">• Not relevant – should assume the network is	<ul style="list-style-type: none">• Not reviewed

	<ul style="list-style-type: none"> be already included in O&M. Risk of double counting. 	<ul style="list-style-type: none"> in place Common practice to include in O&M. 	
Trench Sharing	<ul style="list-style-type: none"> Under estimates sharing in new estates, with third parties and with other Telstra services. 	<ul style="list-style-type: none"> Recommends using long-term equilibrium to increase sharing in the model. 	<ul style="list-style-type: none"> Under estimates ability to share. Sharing between CAN and IEN understated.
Network Design (Rectilinear distances)	<ul style="list-style-type: none"> Significant concerns about use of rectilinear distances Overstates real distances and costs. 	<ul style="list-style-type: none"> Use of an uncorrected rectilinear distance factors likely to overstate rural costs. 	<ul style="list-style-type: none"> Use of rectilinear distances likely to overstate rural costs Recommends use of clustering algorithm to improve DA design
Minimum Spanning Tree (MST)	<ul style="list-style-type: none"> Use of MST not reasonable as it leads to inefficient use of copper and therefore overstates costs. 	<ul style="list-style-type: none"> Recommends correction factors be applied to MST results to ensure costs are optimal. 	<ul style="list-style-type: none"> MST likely to overstate trench lengths and overstate costs.
Technology	<ul style="list-style-type: none"> Insufficient account taken of alternative radio/satellite technology to reduce costs associated with trenching/copper. 	<ul style="list-style-type: none"> PIE II cannot be regraded as a forward looking model based on best practice technology. 	<ul style="list-style-type: none"> Questions whether technology used represents Modern Equivalent asset. Design rules do not reflect Telstra's practice nor least cost design rules.

2.6 The above summary represents a comprehensive weight of evidence against the reliability of the assumptions underpinning the output from the PIE II model.

2.7 Further, as noted in Optus' submission to the ACCC's discussion paper on the undertaking, the PIE II model does not take any account of Telstra's plans to implement a forward looking IP network. These plans were discussed in Optus' submission to the discussion paper and are also referenced in section 6 below.

Use of Historic and Current Cost Accounting Data

2.8 The ACCC has presented information drawn from both Telstra's historic cost and current cost RAF accounts to assess the reasonableness of the cost outputs from PIE II and, therefore, Telstra's proposed undertaking prices.

2.9 The ACCC's analysis demonstrates that Telstra's networks costs as measured in its RAF data, both on an historic and current cost basis, are considerably lower than the network costs estimated by PIE II. **c-i-c**

2.10 **c-i-c**

2.11 This is a very relevant and damning piece of analysis for Telstra. It supports the views presented by Optus and others that the PIE II model significantly overstates Telstra's cost. The output from PIE II quite clearly fails the "smell test" that a cost estimate for a network based on forward looking efficient design principles ought to be significantly lower than that based on historic cost with all its attendant inefficiencies. It also reinforces the view that the proposed access prices are significantly above those that would be reasonable or necessary to protect Telstra's legitimate business interests.

- 2.12 Whilst it is generally accepted that TSLRIC is an appropriate cost measure to set PSTN OTA prices, this approach should not be followed blindly. Any output from a TSLRIC cost model should be compared to the equivalent historic cost for providing the same service. If the TSLRIC cost estimate is higher than the historic cost estimate then Optus submits that it would not be reasonable to set PSTN prices on the basis of the TSLRIC estimate.
- 2.13 A discussion on the appropriate approach to setting Telstra's PSTN prices is set out in Optus' submission to the ACCC on a "Tender for Cost Modelling of fixed network services (September 2006)". Optus has also submitted this paper in respect of the ACCC assessment of Telstra's undertaking. This submission makes the point that whilst TSLRIC is an appropriate concept for modelling the fixed network costs;

"network elements and technology choices that are protected from optimisation in the model should not be subject to forward looking costing if this leads to a higher cost than what has been incurred historically".

2.14 **c-i-c**

2.15 **c-i-c**

3. Packaged approach

- 3.1 Optus supports the ACCC's conclusion that Telstra's proposed packaged approach to PSTN OTA and LCS charges is not reasonable since it;
- (a) would not promote the LIE;
 - (b) would result in Telstra recovering more than is necessary to promote its legitimate business interests;
 - (c) would harm the interests of persons who have rights to use the PSTN OTA service; and
 - (d) would result in prices exceeding cost.
- 3.2 In its submission to the discussion paper Optus noted that Telstra has misallocated costs between local and PSTN calls, with the result that PSTN OTA prices are significantly above the direct costs of supply. **c-i-c**.
- 3.3 In its draft decision the ACCC has suggested that the packaged approach will favour resellers and discriminate against facilities based competitors in the fixed line market. Optus submits that this is a very plausible explanation for Telstra's about face on LCS pricing. Since the late 1990's, Telstra had consistently argued for higher LCS prices as the use of resale increased. However, faced with the prospect of some significant scale resellers migrating their businesses to ULLS, Telstra has sought to shift costs from LCS to PSTN.
- 3.4 Such an approach makes resale more attractive and discourages other resellers from investing in facilities based competition. It also penalises those investing in facilities by increasing their costs of supply and making it harder for them to compete head-on against Telstra Wholesale.
- 3.5 Telstra is actively pursuing this strategy in the market. Optus notes that since the undertaking was lodged Telstra Wholesale has been actively trying to win wholesale share in the switchless resale market. Switchless resellers typically use Telstra's Local Call Service in combination with a long distance call termination service which may be provided by Telstra or another wholesale carrier. Telstra's current strategy is to offer the discounted LCS to win the long distance call termination business. Whilst the long distance call

termination services uses the same network elements as PSTN OTA, Telstra has not increased the prices for this service. Telstra's offer is, therefore, very attractive to switchless resellers.

- 3.6 The reality is that if this undertaking is accepted, wholesale competitors are unlikely to be able to match Telstra's offer since their call termination prices will have to increase to reflect the higher PSTN OTA prices for carrying calls on Telstra's network¹. Optus understands that Telstra Wholesale account managers have been actively promoting this fact to destabilise resellers' existing relationships with competitors to Telstra Wholesale.

4. Averaging of prices

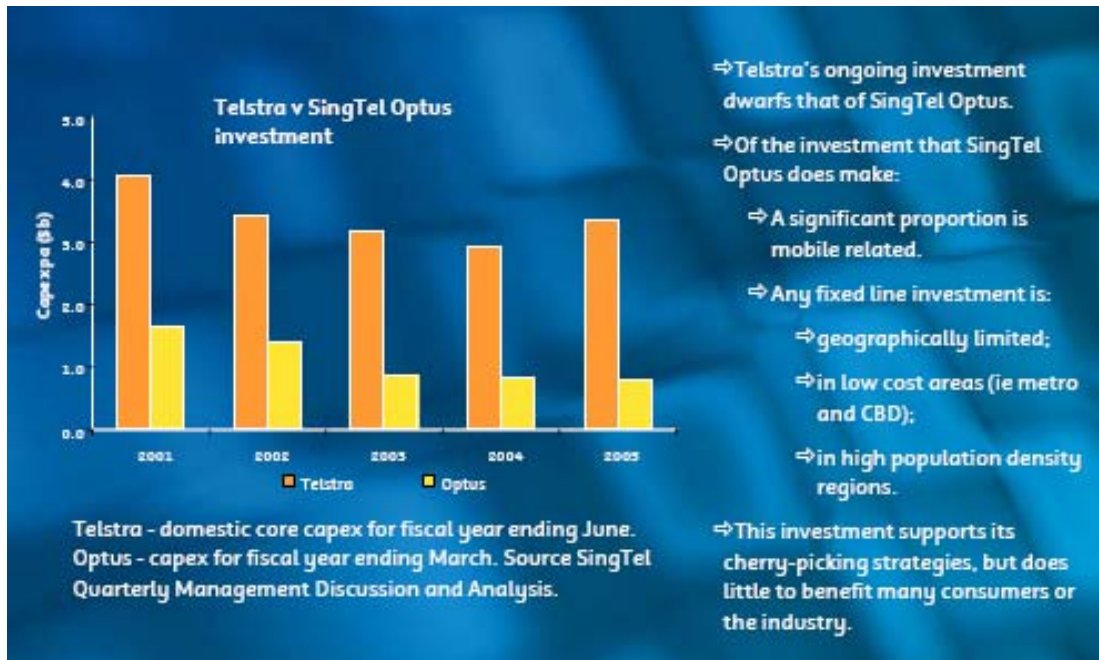
- 4.1 Optus supports the ACCC's conclusion that the averaging of costs implicit in Telstra's PSTN OTA charges is not reasonable since this will:
- (a) Adversely affect competition; and
 - (b) Distort investment decisions and encourage inefficient use of and investment in infrastructure.
- 4.2 Optus' views on averaging were outlined in its submission to the discussion paper, which noted that price averaging proposed by Telstra is not consistent with the LTIE provisions of the TPA.
- 4.3 Optus notes that Telstra has put forward no real evidence or arguments to support its proposed averaging approach. **c-i-c.**
- 4.4 PSTN OTA is predominantly used as an input for the provision of long distance call services. There is no obligation on Telstra to set uniform long distance prices. **c-i-c.**

5. Telstra's legitimate business interests and incentives to invest

- 5.1 Optus submits that rejection of the undertaking will have no impact on Telstra's legitimate business interests nor its incentives to continue to invest.
- 5.2 As noted by the ACCC and Optus in its submission to the discussion paper, the prices proposed by Telstra in its undertaking will exceed the direct costs of providing the undertaking services. **c-i-c.**
- 5.3 **c-i-c.**
- 5.4 In its response to the draft decision Telstra will no doubt argue that if the undertaking prices are not accepted it will not be in a position to recoup its costs which in turn will limit its incentives to invest in the PSTN. Such an argument is not supported by an examination of Telstra's recent and current investment plans.
- 5.5 Firstly, since the late 1990's the ACCC has continued to mandate reductions in Telstra's PSTN OTA prices. In 2003, the ACCC issued indicative prices that signalled continued reductions in PSTN prices to around 0.7 cents/min by 2006-07, the first year of this current undertaking. Notwithstanding these cost reductions, Telstra has continued to invest in its fixed line network. This is demonstrated by the following slide that Telstra presented at its Regulatory Briefing to Investors in December 2005.

¹ The wholesale carrier offering the call termination service will arrange for calls to be terminated to its own and any other network. It will incur PSTN OTA charges for calls terminating on the Telstra network.

Telstra's Investment Commitment



5.6 When seeking to favourably compare itself to Optus, Telstra clearly talks-up its level of investment in the fixed line network.

5.7 Further, as outlined in its investor briefing of November 2005, Telstra is currently undertaking a significant upgrade to its core fixed line network. Under this programme, Telstra will replace the current PSTN core network with a fully integrated IP based Next Generation Network. Optus submission to the ACCC's discussion paper outlined Telstra's plans in some detail. However, the following extract from Telstra's 2006 Annual Report indicates that these plans are now well advanced.

next generation network (NGN)

We are constructing a state-of-the-art Internet Protocol (IP) Core network. The new network will enable us to offer an array of new services such as broadband internet access many times faster than today's speeds, multi-channel TV delivered over the internet and video conferencing.

The new IP Core platform will be 77 times faster than the existing platform capacity. It will provide users with more reliable and stable media and telephony services and expand dramatically the number and range of services any individual customer can use.

- IP Core network well advanced with one third deployed since 1 July 2005
- Alcatel IP-DSLAM technology tested and integrated into the Telstra network
- In August 2006, we opened the Telstra Integration Laboratory in Melbourne. The laboratory will conduct end-to-end testing of the IP core network and associated new products