11 March 2004

Chris Pattas
Senior Director
Australian Competition and Consumer Commission
GPO Box 520J
Melbourne VIC 3000

By facsimile: (03) 9663 3699

Dear Mr Pattas

Telstra's Undertaking for the Line Sharing Service

Optus welcomes the opportunity to comment on Telstra's recent line sharing service (LSS) Undertaking in which a monthly charge of $15 per service is proposed.

Optus firmly believes that the ACCC has no option but to reject the Undertaking. Telstra's proposed price is significantly in excess of the efficient forward-looking costs of service provision, and is a clear example of Telstra's attempts to game the regulatory system.

Further, the cost modelling accompanying the Undertaking is completely at odds with a TSLRIC pricing methodology in that it embodies a range of inefficient costs. Consequently, the ACCC should disregard Telstra's cost model for the purposes of assessing this Undertaking.

Optus has identified a range of means through which Telstra has inflated the efficient costs of service provision. Each of these will now be addressed in turn.

Telstra's capital costs overestimated

Telstra's LSS cost model contains provisions for capital expenditures associated with developing software for network and front of house systems. These costs amount to **[Start: Commercial-in-confidence] [End: Commercial-in-confidence]**

Optus believes that such expenditures have no place in a TSLRIC model. This is because, by definition, TSLRIC is intended to measure the forward-looking efficient costs of service provision. In Optus' view, capital expenditures of **[Start: Commercial-in-confidence] [End: Commercial-in-confidence]** represent a significant divergence from efficient capital cost levels.

Specifically, the ordering and provisioning of LSS is performed over Telstra's Linx Online Ordering (LOLO) system. This system is used not only for LSS, but for all of Telstra's wholesale products including: voice, value added services, data and DSL services (Telstra

Wholesale DSL Layer 2 Internet Grade, Telstra Wholesale DSL Layer 3 Asymmetrical, and Telstra Wholesale DSL Layer 3 Symmetrical).

Given the small number of line sharing services that are ordered and provisioned relative to the remainder of Telstra's wholesale products, the incremental costs imposed by LSS on LOLO will be very close to zero. In particular, if LSS did not exist, LOLO would still have been developed and implemented to almost identical specifications, if not exactly identical.

Optus believes that size of the investment identified by Telstra is not incremental, and is likely to represent a simple reallocation of staff resources and capital from the ordering and provisioning of other wholesale services. The ACCC should consider engaging an independent audit to verify these facts.

Optus is unaware of any additional LSS specific software needed to support the network and front of house systems. Even if Telstra could prove that additional software was developed to perform functions over and above those performed by LOLO, then the ACCC should not accept those costs as part of a TSLRIC calculation. Because LOLO performs a broad range of functions, the scope of any other needs specific to LSS would be extremely minimal, particularly in light of the small number of line sharing services in operation. Capital expenditure on systems to process such functions could not therefore be justified from on efficiency perspective. Indeed, it should be noted that Optus has not ordered any line sharing services to date. According to the ACCC's discussion paper, demand has been similarly low from other access seekers with only 28 LSS lines in operation as at 25 September 2003. At this level of service provision, Telstra need only have invested in a biro and a paper note pad to process LSS orders. It does not require a mainframe computer.

Until demand for LSS increases significantly, investment in and employment of systems and staff to support LSS would represent inefficient practice. The principle behind TSLRIC is that prudent investment should be rewarded. Recovery by Telstra of the capital costs contained in Telstra's cost model would delay demand, particularly if the unrecovered amounts were carried forward to future access prices as proposed by Telstra.

Inclusion of inappropriate direct operational and maintenance costs

Telstra's direct operational and maintenance (O&M) costings provide for a full time equivalent wholesale product manager to manage the sales of LSS. This cost category should not be reflected in access prices. Any activities relating to the sales of LSS should be reflected in the costs associated with the front of house service operations group[1]. Any sales related costs over and above those performed by that group should be considered a commercial activity undertaken by Telstra to enhance its profitability. It is inappropriate to require access seekers to pay for these functions.

In any case, given that there is a limited market for LSS and the fact that access seekers sought access to this service via declaration it is unlikely that Telstra would undertake any sales and marketing for the line-sharing product. Optus is not aware of any Telstra sales related activity that has been directed at encouraging LSS take up. This sales activity is

[1] According to Telstra, the front of house service operations group handles enquiries from access seekers, processes orders for the line sharing service and undertakes related tasks. The costs associated with this group comprise the second category of direct costs in Telstra's cost model.

obviously different to retail sales activity aimed at DSL take up which should not be attributed to the cost of line sharing.

Indirect operational and maintenance cost percentages too high

Telstra has applied indirect O&M percentages of **[Start: Commercial-in-confidence] [End: Commercial-in-confidence]** for front of house service operations, and **[Start: Commercial-in-confidence] [End: Commercial-in-confidence]** for wholesale project management[2].

Optus has two issues with Telstra's treatment of the indirect O&M percentages. Firstly, it is likely that these percentages exceed efficient indirect cost levels. Secondly, the basis for allocating these percentages to the line sharing service appears to be based upon flawed logic.

In relation to the first point raised above, Telstra bases its level of indirect costs on historical costs incurred by Telstra in the provision of services. The use of historical costs can introduce significant distortions and cost overestimations, as these costs may embody inefficient indirect O&M practices and expenditures. Indeed, Telstra has historically enjoyed an institutional and regulatory environment that provided very few incentives for cost minimisation or operating efficiencies. It is well recognised by economists that public monopolies operating under rate of return regulation will tend to over capitalise and gold plate their operating practices.

In relation to the second point, Telstra's Undertaking appears to allocate the indirect O&M costs to LSS on the basis of the level of direct O&M costs associated with LSS. Optus submits that this approach is entirely inappropriate. There is no sound logic for allocating the average company-wide O&M percentage to a single service, particularly given the variability of the amount of capital embodied in each service across the various products.

Optus believes that staff numbers provide a far better basis for estimating the appropriate proportion of indirect costs attributable to LSS. This is because, by and large, the indirect costs are driven by the size of a company's workforce rather than the value of capital embodied in the firm. Given that staff numbers associated with LSS is limited, the indirect costs allocated to the service should be heavily discounted, if not approaching zero.

Telstra's cost modelling inconsistent with decision to submit Undertakings

[Start: Commercial-in-Confidence] [End: Commercial-in-Confidence]

Telstra's Undertaking is incomplete

Optus notes that Telstra's Undertaking does not include a full list of charges applicable with the provision of LSS. As a general principle, the ACCC should reject an Undertaking which does not present all the likely charges, because it has no basis to determine the likely overall costs of the service.

Undertakings must be rejected

[2] This O&M percentage is irrelevant if wholesale project management costs are omitted from the analysis.

This letter identifies a range of means through which Telstra has overestimated the efficient costs of providing LSS. Optus believes that when each of these factors is taken into account, the true costs of LSS provision are less than $5 per month. Optus would be happy to meet with the ACCC to expand on the basis for this calculation.

Given the evidence presented above, Optus submits that the ACCC has no option but to reject Telstra's line sharing Undertaking. Any moves to the contrary would clearly harm the long-term interests of end users. In particular, there is unlikely to any uptake of LSS at a rate of $15 per month.

If you have any questions about any elements of this letter, please do not hesitate to contact me on (02) 9342 7036 or Sara Whyte on (02) 9342 5125.

Yours sincerely

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