30 May 2006

Mr Andrew Deitz
Australian Competition and Consumer Commission
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By facsimile: (03) 9663 3699

Dear Andrew

Optus comments on ACCC's draft decision on the Local Carriage Service ("LCS") Review

This letter sets out some brief comments from Optus in respect of the ACCC's draft decision on the LCS declaration.

Extension to LCS declaration

Optus supports the ACCC's proposed decision to extend the current declaration until June 2008. Whilst Optus anticipates that successful execution of its broadband strategy will change the dynamics of the wholesale local calling market, this will take time to be realised. It would be extremely premature to wind-back the regulation of LCS at the current time.

Declaration of a wholesale line rental service

Optus supports the ACCC's proposal to declare a line rental service. As identified by the ACCC, declaration of that service has the potential to promote competition in downstream markets. However, declaration alone is unlikely to be sufficient to achieve this objective. It must be combined with some fundamental changes to the pricing of the line rental and the local carriage service.

Pricing of LCS

Optus is disappointed that the ACCC has failed to grasp the opportunity afforded by this declaration inquiry to restructure the pricing of Telstra's LCS and wholesale line rental services such that Telstra's current incentive and ability to price LCS anti-competitively is removed.

Fails to address discriminatory pricing

As the ACCC is aware, the issue of discriminatory pricing by Telstra in relation to LCS has existed for some time. The ACCC has recognised the potential for it to occur as far back as its *Access Pricing Principles – Telecommunications a guide* when it concluded that:

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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.

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. 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.

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. (page 15)

As set out in Optus' submission the most practical way to address this matter is to set wholesale line rental and LCS prices on a TSLRIC basis where this is found to result in a price below that produced by the current Retail Minus Retail Cost approach.

Fails to deal with pricing imbalance

Further, Optus remains troubled that the current RMRC approach also leaves resellers facing higher costs than those faced by Telstra Retail. In its briefing pack of 11 August "Telstra: The Path Forward", Telstra indicated that it currently enjoys EBITDA margins of 54.3% on Local Calls and 55% on Basic Access services. These margins appear totally at odds with an access pricing regime that applies no discount to Basic Access and only a 32% discount to Local calls. There is a clear need for a fresh examination of Telstra's costs.

Fails to deal with Telstra's Regulatory gaming

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, successfully managed to squeeze the margin earned by competitors using LCS.

For example, the wholesale LCS rate proposed by the ACCC in April 2002 was approximately 12.35 cents per call (reflecting the mix of local and neighbourhood calls). This increased to 13.61 cents in 2003. One reason for the increase was because the ACCC allowed Telstra to game the starting price under the retail minus framework, by removing the cheaper neighbourhood calls from its unbundled Homeline Part packages with the result that the starting prices for these packages was higher than that for its bundled retail packages. The ACCC also accepted, with little scrutiny, Telstra's evidence that its retail costs avoided had reduced.

As Optus demonstrated to the ACCC in 2004[1], Telstra's conduct in offering lower per call prices to customers who take HomeLine Complete or HomeLine Plus effectively creates a 'price shield.' This means that Telstra customers enjoy an advantage by taking line rental and local calls from Telstra, as compared to a competitor, and competitors can only overcome this advantage by offering steeper discounts on preselect services than those which Telstra offers. That is, Telstra is protected by a 'price shield' which tends to impede competition. Again, the ACCC declined to take action.

The latest example of Telstra's cynical gaming of LCS pricing is in its PSTN and LCS undertaking which has recently been lodged. Remarkably, Telstra finds it has been in error all these years, and in fact the true LCS price, calculated on a retail minus basis, is much lower than it once was. However, true to form there is an unsubtle twist, since Telstra claims that the amount by which LCS is reduced must now be recovered from PSTN originating and terminating charges. Either Telstra is wrong now - or it was wrong in the past. In either event, firm regulatory action is called for.

Against this backdrop, Optus is extremely disappointed that the ACCC has once again failed to take decisive action to prevent Telstra's gaming of LCS pricing. We urge the ACCC to revisit this issue; to break decisively from its laissez faire approach and instead to tackle this issue head-on.

Rapid process to introduce new model is vital

Whilst Optus is encouraged by the ACCC's proposal to develop a more robust and independent TSLRIC cost model with a view to re-evaluating its current pricing principles, this work ought to be far more advanced. Optus, therefore, encourages the ACCC to expedite this initiative and is willing to commit resources and intellectual property to assisting the ACCC.

In approaching this work Optus recommends that the ACCC draws on international best practice by seeking to use an existing model that could be manipulated for Australian conditions. There is now a wealth of work on PSTN costing which means there is no need for Australia to seek to reinvent the wheel. In addition, recent regulatory processes undertaken by the ACCC mean that there is a wealth of data available for input to such a cost model.

[1] Optus submission to the ACCC, LCS Undertaking price is anti-competitive (March 2004)

Model must reflect Telstra's lower costs

One critical question which needs to be tackled head on to ensure that any new modelling work has a degree of longevity is to establish the network design parameters for a truly forward looking efficient cost model. Telstra's recently announced plans to upgrade its core network to a Next generation Network architecture and its proposed FTTN roll-out indicate without any doubt that the traditional copper based switched network architecture, as depicted by PIE II, is no longer an appropriate forward looking network design. Any new model will necessarily have to take into account the plans announced by Telstra in its Technology Briefing of 16 November 2005, that are clearly designed to reduce Telstra's costs:

"Involved in core transformation is a journey to a unified common packet core... The keys to success in this area are going to include meeting rapid growth through scalability options that lower our unit cost, about dramatically increasing our reliability through in part better design, in part new infrastructure, and in part retiring some of our older infrastructure". (Bill Felix – Transcripts page 9).

"Okay. On the first part regarding decommissioning of the parts of the PSTN whether it's a next class 5 exchange switch etc. We are going to have like-for-like services and I think Jamie was pretty clear on that that we are just going to run it over a lower cost infrastructure so there shouldn't be any regulatory issue whatsoever because we are providing like services to what we provide today as far as from an end user viewpoint. If they choose to maintain the same types of services they have with Telstra, or if it's resold through one of the wholesale agreements, it will be the same type of service, we are just going to run it on a lower cost infrastructure". (Gregg Winn - Transcripts page 32).

Yours sincerely

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