Australian Competition & Consumer Commission

Pricing principles and indicative prices

Local carriage service, wholesale line rental and PSTN originating and terminating access services

Final Determination and Explanatory Statement

29 November 2006

Explanatory Statement

Chapter 1. Introduction

Once a service is declared under Part XIC of the *Trade Practices Act 1974* (the Act), the Australian Competition and Consumer Commission (the Commission) has the following responsibilities:

- it may make a telecommunications access code, which sets out the model terms and conditions for access to declared telecommunications services[1];
- it must accept or reject undertakings submitted by access providers, which may include the terms and conditions of access to declared telecommunications services or the model terms and conditions set out in the telecommunications access code[2]; and
- arbitrate disputes between parties concerning the terms and conditions of access to declared telecommunications services.[3]

These tasks may involve approving or determining a price for the declared service, or a method for ascertaining a price.

The Commission is required by s.152AQA of the Act to determine, in writing, principles relating to the price of access to declared services. The determination may also contain price-related terms and conditions (indicative prices) relating to access to the declared service. The Commission must make such a determination at the same time as, or as soon as practicable after, the Commission declares a service. The Commission is also required to publish a draft of the determination, invite submissions on the draft and consider any submissions received, before it makes a final pricing determination.

Once the Commission has made pricing principles determination, it must have regard to the determination if it is required to arbitrate an access dispute.[4] However, the pricing principles are not binding on the Commission and parties to arbitrations are still able to address the Commission on the relevance and applicability of the principles having regard to the circumstance of their dispute. The Commission considers that, although a party may argue against the principles being applied to its particular case, pricing principles will guide commercial negotiation of access by providing greater certainty as to the Commission's views on reasonable access prices.[5] Further, the Commission may also have regard to commercially negotiable prices for other declared services which use inter-related network elements (for example, LCS and PSTN OTA) to ensure Telstra's recovery of efficient costs.

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1 Part XIC, Division 4 of the Act.

2 Part XIC, Division 5 of the Act.

3 Part XIC, Division 8, Subdivision C of the Act. Under the *Telecommunications Act 1997*, the Commission also has responsibilities to arbitrate disputes over the terms and conditions for matters such as preselection and number portability.

4 s.152AQA(6) of the Act.

5 See: Commonwealth, *Trade Practices Amendment (Telecommunications) Bill 2001*, pp. 10, 18.

The purpose of this determination is to inform industry, government and other interested parties on the principles and indicative prices that are likely to guide the Commission when considering an access dispute or assessing an undertaking in relation to pricing for the Local Carriage Service (LCS), Wholesale Line Rental (WLR) and Public Switched Telephone Network Originating and Terminating Access (PSTN OTA) services.

The ACCC, however considers that any indicative prices relating to the pricing of LCS and WLR for 2006-07 will be transitional in nature. They will stay in place while the ACCC undertakes more detailed analysis on assessing efficient LCS and WLR costs and prices using appropriate costing models.

Background

In July 1997, the Commission published *Access Pricing Principles: Telecommunications — a Guide* (the Guide). The purpose of the Guide was to advise the telecommunications industry and other interested parties about the principles that are likely to be relevant in assessing undertakings or in arbitrating access disputes. It set out the following broad principles:

- the access price should be based on the cost of providing the service;
- the access price should not discriminate in a way which reduces efficient competition;
- the access price should not be inflated to reduce competition in dependent markets; and
- the access price should not be predatory.

In the Guide, the Commission noted that when determining a cost-based price, it would generally seek to determine the Total Service Long-Run Incremental Cost (TSLRIC) of providing the service. However, it also noted that the applicable approach would be assessed on a case-by-case basis for each service.

In April 2002, the Commission released pricing principles and indicative prices for LCS because it considered the TSLRIC methodology was not appropriate for this service at that stage. The Commission indicated it would be likely to adopt a retail-minus methodology to determine an access price in the event of a LCS access dispute or when assessing a LCS undertaking. The retail-minus methodology determines the LCS price by subtracting retail costs from the retail price of a local call.

In October 2003, the Commission released its *Final Determination for Model Price Terms and Conditions of the PSTN, ULLS and LCS services*. The Commission specified retail–minus access prices for LCS for 2003-04 and 2004-05, because of the pending review of the LCS declaration and pricing principles in subsequent years. The Commission specified TSLRIC access prices for PSTN OTA for 2003-04, 2004-05 and 2005-06. The Commission has not, until recently declared WLR, hence neither pricing principles or indicative prices have been previously specified for this service.

Consultation

Before making a pricing principles determination, the Commission is required by section 152AQA(4) to publish a draft determination and invite and consider any submissions received.

The Commission has recently held two public inquiries into fixed line declarations – the *Local Services Review*, which considered the declaration of LCS and WLR; and the *Fixed Services Review*, which, amongst other services, considered the declaration of PSTN OTA.

In the case of the Local Services Review, the ACCC published a discussion paper in April 2005 and a draft decision in March 2006. Submissions from interested parties were sought in response to both publications. In the case of the Fixed Services Review, a discussion paper was published in December 2005 and a position paper in June 2006. Again, submissions from interested parties were sought in response to both publications.

On 28 July 2006 the Commission released its final report for both inquiries. In *Local services review—final decision*, the Commission decided to declare the LCS and WLR and published its draft determination on pricing principles and indicative prices for both services. In *Declaration inquiry for the ULLS, PSTN OTA and CLLS—final determination*, the Commission decided to declare the ULLS and PSTN OTA and published its draft determination on pricing principles and indicative prices for PSTN OTA. The Commission invited submissions on the draft pricing principles and indicative prices set out in both decisions by 31 August 2006..

In response to the *Local services review—final decision* and the *Declaration inquiry for the ULLS, PSTN OTA and CLLS—final determination*, the Commission received submissions from Telstra, Optus and the Competitive Carriers Coalition (who also submitted a report prepared on its behalf by Frontier Economics). The Commission has taken these submissions into account in making this determination.

The Commission is in the currently in the process of considering the development of a new cost model for fixed lined services, hence has only produced indicative prices to apply during 2006 and 2007. In the absence of a cost model, the Commission may have regard to these prices throughout 2007. Furthermore the Commission has not published indicative prices for the unconditioned local loop service (ULLS). As there are a number of pricing issues currently being resolved in arbitrations for the ULLS, the Commission does not consider it appropriate to pre-empt this assessment at this time.

These documents are available from the Commission's website www.accc.gov.au.

This document now contains the final pricing principles and indicative prices for the LCS, WLR and PSTN OTA.

This determination is structured as follows:

- Chapter 2 provides an overview of the legislative criteria in Part XIC of the Act, which guide the Commission's decisions when arbitrating access disputes and assessing undertakings;

- Chapter 3 outlines the main pricing methodologies that have been advocated for declared services.
- Chapter 4 contains the Commission’s assessment of the pricing principles and indicative prices for LCS and WLR;
- Chapter 5 contains the Commission’s assessment of the pricing principles and indicative prices for PSTN OTA;
- Chapter 6 contains a discussion of local call override;

Appendix A sets out the submissions received in relation to the Commission’s draft pricing principles and indicative prices.

Appendix B is the instrument setting out the pricing principles and indicative prices approved by the Commission under section 152AQA.

Chapter 2. The relevant legislative criteria

The object of Part XIC of the Act is to promote the long-term interests of end-users (the LTIE) of carriage services or of services provided by means of carriage services.[6] This will be achieved, in part, through establishing the rights of third parties to gain access to services that are necessary for the competitive supply of services to end-users.

An important part of the access regime is the terms and conditions of access (including the price or a method for ascertaining the price). Under Part XIC of the Act the Commission cannot make a telecommunications access code or accept an undertaking unless satisfied that the terms and conditions specified are reasonable.[7] In determining whether terms and conditions are reasonable, regard must be had to the following matters:

- whether the terms and conditions promote the LTIE;
- the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or carriage service 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.[8]

This does not, by implication, limit the matters to which regard may be had.[9]

When arbitrating access disputes the Commission must have regard to the same matters. In addition, the Commission must take into account in making a determination the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else.[10]

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6 Sub-section 152AB(1) of the Act.

7 The Commission must also ensure that the terms and conditions in the TAF access code, in undertakings and any arbitration determination is consistent with any Ministerial pricing determination in place. See section 152CH of the Act.

8 Sub-section 152AH(1) of the Act.

9 Sub-section 152AH(2) of the Act.

10 Paragraph 152CR(1)(e) of the Act.

Chapter 3. Pricing principles

Introduction

As outlined in the Local Service Review, July 2006[11], the ACCC considers that there are two main pricing principles for pricing the declared services—the retail-minus-retail-costs (RMRC) approach and the cost-based approach.

RMRC is a 'top-down' approach that takes the retail prices paid for the declared service and deducts the avoidable costs of retailing the service to end-users to calculate an access price. A cost-based approach, in comparison, is a 'bottom-up' approach that models the costs of the various network elements necessary for use in the service (and also, typically, allocates common costs).[12] Where the retail service and wholesale service are the same product, and where retail prices are strictly cost-based, the two pricing approaches will lead to (approximately) the same access price.

However, the approaches will more often lead to divergent access prices. Of particular relevance are the following two scenarios:

- If retail prices are held below costs (which may be the case due to the government's retail price control regime), a RMRC approach will lead to lower access prices than a cost-based approach.
- If retail prices are above total (wholesale + retail) costs, then the access seeker is making some level of economic profits. A RMRC price will be higher than cost-based prices because it will reflect this level of economic profit. The access provider would accordingly retain these profits from the RMRC price at the expense of access seekers and/or access seekers' end-user customers. A cost-based approach would not preserve this profit.

The relative levels of price and cost is clearly a crucial factor in determining whether a RMRC or cost-based pricing approach is most appropriate under the reasonableness criteria.

Total Service Long-Run Incremental Costs

TSLRIC represents the costs that an efficient operator would incur in conveying local calls over the long run. TSLRIC can be understood by separating it into its components:

- 'total service' refers to it being the cost of production of an entire service (or a production element) not to the cost of a particular unit;

- 'long-run' refers to it being a long-run cost concept in contrast to a short-run one. In the long-run all factors of production can be varied; and

[11] ACCC Local Service Review, July 2006

[12] The ACCC has typically chosen to apply the Total Service Long Run Incremental Cost (TSLRIC) approach when applying a cost-based pricing methodology.

- ‘incremental cost’ means that it is the ‘marginal cost’ of producing the total service, and it is distinct from the ‘marginal cost’ which estimates the change in cost incurred by a unit change in output produced.

TSLRIC is also an attributable cost concept as it refers only to those costs that can be attributed to the production of the service. Costs common to more than one service cannot be attributed to a particular service and therefore do not form part of TSLRIC. However, in practice, it is sometimes defined to include a contribution to common costs (‘TSLRIC+’).

The TSLRIC methodology

TSLRIC measures the incremental or additional cost the firm incurs in the long term in providing the service, assuming all of its other production activities remain unchanged.

TSLRIC represents an estimate of the costs that an efficient firm would incur in providing the service over the long run. As already mentioned, these costs can be specific to the particular service or additionally include costs that are ‘common’ to a range of services (i.e. TSLRIC+). Common costs are the costs incurred in the provision of a group of services, which are not avoided unless the production of all services ceases.

To estimate costs, a forward looking approach is adopted. Given that TSLRIC is a long-run cost measure, the time horizon is sufficient so all necessary investments can be replaced. Thus, the cost of efficient forward-looking investment in long-lived assets required to produce network services is included in TSLRIC+ even if some or all of the investment will become sunk once in place.

The Commission has used TSLRIC-based pricing to price other declared services (e.g. the Domestic PSTN Originating and Terminating Access services). In general, it considers such pricing to be appropriate for services:

- that are well developed;
- that are necessary for competition in dependent markets; and
- where the forces of competition or the threat of competition work poorly in constraining prices to efficient levels.[13]

According to the Commission’s 1997 guide on Access Pricing Principles, an access price based on TSLRIC would be consistent with the price that would prevail if the access provider faced effective competition, and would usually best promote the LTIE. It would:

- promote efficient entry and exit in dependent markets since prices are based on long-term costs;
- encourage economically efficient investment in infrastructure by providing for a normal commercial return on efficient investments in infrastructure;

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13 Australian Competition and Consumer Commission, *Access Pricing Principles: Telecommunications – a Guide*, 1997, pp. 27-28.

- provide for the efficient use of infrastructure as access prices are based on the long-term value of the resources embodied in that service;

- provide incentives for access providers to minimise the costs of providing access by using best-in-use technology compatible with existing network design to measure cost;

- allow efficient access providers to fully recover the costs of producing the service, and promote the legitimate business interests of the access provider; and

- inhibit the access provider discriminating in favour of one access seeker over another (unless the discrimination is based on differences in costs).[14]

Retail-minus methodology (RMRC)

Under a retail-minus methodology, the access price is determined by deducting the access provider's retail costs from the retail price for a given service.

This methodology has been expressed in a number of ways. Sometimes, it is expressed as 'retail-minus avoidable costs', and in other instances as simply 'avoidable costs'. Avoidable costs are regarded as costs that an access provider would avoid, or can avoid, if it ceased provision of retail activities completely in respect of the service in question (e.g. local calls).

On some occasions, a distinction is also made between avoidable costs and avoided costs. Avoidable costs are the costs that an access provider could avoid if it ceased retail operations completely, whereas avoided costs are those costs that the access seeker *actually* avoids when it ceases retailing to the end-users who are now supplied by its competitor.

Telstra, in an earlier submission, stated:

> "…the avoidable cost standard sets a wholesale discount by reference to assumed costs which would be saved by an access provider if it ceased retailing altogether, whereas in the real world Telstra supplies local calls for resale in circumstances where it will, regardless of whether resellers purchase service from it for resale, incur significant fixed costs."[15]

What is sought to be measured, however, is not so much the quantum of costs that the access provider could conceivably avoid through its supply of wholesale services but rather the average retail cost of supplying a particular service (e.g. local calls). In this regard, the definition of avoidable costs provides a means of identifying and estimating retail costs. That said, the Commission acknowledges that the terminology 'avoidable costs' is capable of creating the impression that the access provider can avoid those costs, when in reality this may not occur. Consequently, the Commission has chosen to express the methodology as 'retail-minus retail costs'.

Finally, the Commission notes that, in a competitive market in the absence of retail price regulation, the retail-minus price and TSLRIC-based price should converge.

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[14] Ibid, pp. 29-30.

[15] Telstra submission 1 September 2000.

Chapter 4. Pricing Principles for LCS and WLR

Pricing principles for LCS and WLR

This section explains the ACCC's pricing principles determination for the LCS and WLR services (together the 'declared services'). The ACCC has considered and analysed the submissions of interested parties in response to its Discussion Paper released in April 2005 and draft decision on pricing principles released in July 2006. The ACCC's draft pricing principle determination was released in that draft decision.

Section 152AQA(2) of the TPA outlines that a pricing principle determination made by the ACCC may also contain price-related terms and conditions relating to access to the declared service.

The ACCC's pricing principles

The ACCC published draft pricing principles in Chapter 10 of its final decision for the Local services review.[16] The draft pricing principles proposed that a retail-minus-retail-cost (RMRC) pricing principle should be maintained as an interim pricing approach.

However the ACCC noted that the decision between a RMRC pricing principle and a cost-based pricing principle was not clear-cut. In particular, the choice between the two principles depended significantly on the relativity between retail prices for the local call and line rental products and the cost of providing the LCS and WLR products.

As noted in Chapter 10:

- If costs are below the RMRC access price for the service, then a cost-based approach would be more likely to be reasonable.
- if RMRC access prices are below costs, then a RMRC approach would be more likely to be reasonable.

The ACCC considers that no definitive view can be made on which pricing principle to adopt, but notes that in the absence of a robust cost model capable of producing reliable estimates of costs in all geographic regions it would be difficult to conclude that cost-based pricing should be adopted.

However the ACCC considers that, once it has constructed a robust cost model, capable of producing reliable cost estimates in all geographic regions, it should seek to implement a cost-based pricing approach. While the choice between RMRC and cost based pricing approaches is closely balanced on an assessment of the reasonableness criteria, the ACCC notes that the evidence presented to this declaration review suggests that retail prices and RMRC access prices currently exceed cost-based prices, particularly for WLR.

The ACCC also considers that moving towards a future implementation of a cost-based pricing approach is appropriate for the following reasons:

[16] ACCC Local Service Review, July 2006

- greater consistency with pricing of other access services
- widespread industry support for a cost-based model
- greater relevance for the pending development of the cost model
- certainty for industry about future pricing.

The ACCC's view is therefore to adopt an interim RMRC pricing approach. The ACCC will seek to implement a cost-based pricing approach for the declared services once it has access to a robust cost model, and will consult on issues relating to the transition to cost-based pricing at that time.

Indicative prices for LCS and WLR

The ACCC issued draft indicative prices for WLR and LCS as shown in Table 1[17].

Table 1 Draft indicative prices for WLR and LCS

	Residential	**Business**
WLR	$23.57 ex GST	$26.30 ex GST
LCS	17.69c ex GST	17.69c ex GST

Both indicative prices and model price terms and conditions are designed to provide guidance to access providers and access seekers involved in negotiating the terms and conditions of access to services, particularly as they would be taken into account by the ACCC in any arbitration of access disputes. They can also act as a guide to parties considering providing access undertakings to the ACCC for particular services.

Indicative prices and model prices provide this guidance by giving parties an idea of the ACCC's views on the appropriate pricing for the declared service.

However the ACCC notes that indicative access prices set out in a determination are non-binding on parties to arbitrations or undertaking assessments. While the ACCC would ordinarily see these access prices as appropriate in a general sense, it must look at specific issues, raised by the parties in particular arbitrations or undertakings, on their individual merits. As such, there will remain potential for an arbitration determination or an approved undertaking to depart from the indicative prices.

The ACCC in July 2006 released its draft indicative pricing relating to the pricing of LCS and line rental. The ACCC, however, 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 using appropriate costing models.

[17] ACCC Local Service Review, July 2006 p 83

In response to the ACCC's draft indicative prices, Telstra, Optus and the Competitive Carriers Coalition (CCC) lodged submissions with the ACCC.

Telstra

Telstra argues that if the ACCC will not use TSLRIC until it has reference to a more reasonable model than the ACCC should determine the RMRC of LCS and WLR in a manner that ensures Telstra fully recovers its efficient costs in the provision of these services.[18]

Optus

Optus[19] major concern is that the ACCC appears to have taken an incorrect starting price to calculate the residential WLR access fee. Optus argues that the ACCC analysis which uses the HomeLine Part plan as its starting point ignores Telstra's new wholesale basic access plan of $27.60. This results in higher overall costs for consumers of local calls and basic access than in Telstra's undertaking.[20]

Competitive Carriers Coalition Views

Frontier Economics in a report prepared for the Competitive Carriers Coalition argue that while the ACCC uses the appropriate principle in identifying relevant retail costs it has not, in setting the draft indicative prices, made certain adjustments to Telstra's data which have been made in the past. Frontier analysis show that the avoidable costs are under estimated by around **[c-in-c]** per local call and by **[c-in-c]** per line.[21]

In applying the RMRC methodology, it is necessary to deduct avoidable retail costs of line rental and local calls from these prices to obtain the RMRC prices for the LCS and WLR. The ACCC has derived 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 2005-06.

Telstra's avoidable costs for the 2005/06 for end-user access and local calls are shown in Table 1.

Table 2: Telstra's avoidable retail costs and volumes for end-user access and local calls, 2005-06 RAF

	End-User Access	**Local Calls**
4-1 Organisational ($m)	**[c-in-c]**	**[c-in-c]**
4-2 Product and Customer ($m)	**[c-in-c]**	**[c-in-c]**
Cost of Capital ($m)	**[c-in-c]**	**[c-in-c]**

[18] Telstra, "Telstra's submission in response to the Australian Competition and Consumer Commission's final determination in the Declaration inquiry for the ULLS, PSTN OTA and CLLS, dated July 2006 and the Australian Competition and Consumer Commission's Final Decision in its Local Services Review dated July 2006" 11 September 2006

[19] Optus' comments on the ACCC's proposed indicative prices for Fixed Line Services 1 September 2006

[20] Telstra's Undertaking is only relevant with regards to LCS charges.

[21] Frontier economics "Indicative prices for wholesale line rental and local call services" A report prepared for the Competitive Carriers Coalition, August 2006

Total Retail Costs ($m)	**[c-in-c]**	**[c-in-c]**
Volume (m)	**[c-in-c]**	**[c-in-c]**
Unit avoidable retail costs for line rental and local calls	**$5.93/mth**	**2.29c/call**

As noted by frontier economics, in producing model terms and conditions for the LCS in 2003, the Commission made a number of adjustments to the retail costs from Telstra's Regulatory Accounting Framework data. This was intended to provide a better representation of Telstra's avoidable retail costs. These adjustments were not included in the draft indicative prices released in July 2006 and have not been included in the determination of the final indicative prices.

In making the decision not to include these adjustments the ACCC wishes to note that in Model Price Terms and Conditions of October 2003, the ACCC quite clearly expressed its reservation regarding the arbitrary nature of these adjustments.[22] Secondly, in assessing whether these adjustments meet the LTIE, the Commission needs to balance the fact that an RMRC-based pricing may on the one hand encourage the build of infrastructure but on the other it may act as a deterrent to facilities-based competition if it prevent access seekers developing sufficient scale to justify establishing their own facilities.[23] Thirdly, the ACCC has noted its preference for a cost-based pricing approach for LCS and WLR and has had discussions with industry on the development of an appropriate cost model.[24]

The ACCC has, therefore, decided not include the adjustments to LCS. Nevertheless, the ACCC remains open for such adjustments to be negotiated or considered by the ACCC in the context of an arbitration decision.

The charges for LCS and WLR are set out below in Tables 3 and 4 respectively; and in Part 1 of Schedule 1 and 2 respectively to the instrument annexed in Appendix B.

Table 3 Final indicative prices for LCS 2006 and 2007

	Local Calls
Telstra Retail Prices	20c ex GST
Unit Avoidable Retail Costs	2.29c/call
GST Adjustment	0.21c
Indicative Price	17.92c

Table 4 Final indicative prices for WLR 2006 and 2007

	HomeLine Part	**BusinessLine Part**
Telstra Retail Prices	$29.05	$31.77
Unit Avoidable Retail Costs	$5.93/mth	$5.93/mth
Indicative Price	$23.12	$25.84

[22] ACCC, "Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services" October 2003

[23] ACCC, "Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services" October 2003 pp 67-68

[24] ACCC, "Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services" October 2003 p 75

Chapter 5 Pricing principles for PSTN OTA services

Pricing principles for PSTN OTA services

The Commission determined in its July 1997 access pricing principles paper that pricing based on total service long-run incremental cost (TSLRIC) to recover the efficient costs of a 'forward-looking' network would satisfy the legislative criteria, which are detailed in Appendix 1 (section A1.3) of this report.[25]

In a practical sense TSLRIC consists of the sum of the operating and maintenance costs, as well as the capital costs that the firm incurs in providing the service as a whole. Operating costs are the continuing operational costs of providing the service, including the labour and materials costs that are causally related to the provision of the service. Capital costs comprise the cost of capital (i.e. the opportunity cost of debt and equity used to finance the firm) and depreciation (i.e. the decline in economic value of assets) of capital that is specific to the production of the service. In practice TSLRIC is usually defined to include a contribution to indirect or organisation-level costs ('TSLRIC+').

The Commission has examined the pricing of the ULLS and PSTN OTA services on numerous occasions.[26] Consistent with its previous views, the Commission considers that TSLRIC is the appropriate pricing principle for the establishment of prices for the ULLS and PSTN OTA. In all cases the Commission has adopted a TSLRIC+ approach to the pricing of these services[27]. It has also adopted a de-averaged approach to the charges for the ULLS monthly rates and the PSTN OTA per minute rates, where charges are set by reference to the costs in different geographic areas.

The Commission published draft pricing principles for the ULLS and the PSTN OTA in *Declaration Inquiry for the ULLS, PSTN OTA and CLLS: Final Determination*, July 2006, which proposed to maintain TSLRIC as the basis for determining prices for the ULLS and the PSTN OTA.

Telstra was the only interested party to comment on the pricing principle. Telstra's comments were in relation to the need for the Commission to consider Telstra's total cost recovery needs

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[25] ACCC, *Access Pricing Principles – Telecommunications – a guide*, 1997.

26 In respect to ULLS, see: ACCC, *Pricing of unconditioned local loop services (ULLS) Final Report March 2002; Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services, October 2003*; *Assessment of Telstra's undertakings for PSTN, ULLS and LCS, Final Decision, December 2004*; *Assessment of Telstra's ULLS and LSS monthly charge undertakings, Draft Decision, August 2005.*

In respect to PSTN OTA see: ACCC, *Assessment of Telstra's Undertaking for Domestic PSTN Originating and Terminating Access, Final Decision, June 1999*; *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services, July 2000; The Need for an ADC for PSTN Access Service Pricing, February 2003; Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services, October 2003; Assessment of Telstra's undertakings for PSTN, ULLS and LCS, Final Decision, December 2004*.

[27] In the case of PSTN OTA, an access deficit component was allowed initially to account for the claimed difference between line costs and line revenues due to retail price controls, but this aspect has been phased out.

across services, its retail market constraints and the technical limits imposed by the service description. Telstra did not raise an objection with the TSLRIC pricing approach per se.

The Commission's final pricing principles determination is therefore to maintain TSLRIC as the basis for determining prices for PSTN OTA.

Indicative prices for PSTN OTA services

In October 2003, the Commission published model prices for the PSTN, ULLS and LCS services.

The Commission notes that model access prices set out in a Determination are non-binding on participants. This means that while the Commission would ordinarily see these access prices as appropriate in a general sense, it is bound to look at any specific issues raised by the parties in individual arbitrations or undertakings, based on their individual merits. This means a determination made in an arbitration will depend upon the particular circumstances of the dispute, as they exist at the time, and similarly an undertaking assessment would need to take account of its specific provisions.

The October 2003 Determination was for a period of 5 years. At the time, the Commission observed that the Determination need not detail model prices for the entire 5 year period. The Commission's view was that estimates for the fourth and fifth years were likely to be less reliable and the Commission concluded that it would be appropriate to issue model prices for the first three years of the Determination.

The Commission also noted that it had the flexibility to revoke or vary the Determination and that this could include a variation to specify details of pricing for the two final years (2006-07 and 2007-08).

The Commission now wishes to provide further guidance in respect to price-related terms and conditions under section 152AQA(2) for the 2006 and 2007 year. It is important to note that the Commission considers that any price-related terms and conditions that it establishes for 2006 and 2007 will be of an interim nature and designed to stay in place while the Commission undertakes more detailed work on assessing efficient PSTN OTA costs and prices. The Commission notes that on 22 March 2006 Telstra lodged access undertakings specifying price-related terms and conditions upon which it undertakes to meet its standard access obligations to supply the PSTN originating and terminating access services (PSTN OTA) and the Local Carriage Service (LCS). On 29 November, 2006 the ACCC released a final decision concluding that it could not be satisfied that terms and conditions upon which it undertakes to meet its standard access obligations to supply the PSTN originating and terminating access services (PSTN OTA) and the Local Carriage Service (LCS) were reasonable.

In these circumstances, the Commission considers that providing some certainty in respect to indicative prices is important to assist as a starting point for any commercial negotiations. Of course, the Commission would expect that bilateral outcomes would vary from the price-related terms and conditions established by the Commission to take account of individual commercial and economic circumstances.

Indicative prices for PSTN OTA for 2006 and 2007

In the October 2003 Determination, the Commission considered that it was important to move to a pure TSLRIC-based PSTN conveyance cost (i.e. with no ADC) by the beginning of 2006-07.

Using PIE II modelling as a guide, the Commission concluded that the call conveyance cost over the 3-year period for which indicative prices would be set was in the vicinity of 0.7 cents per minute. The Commission also noted that even though there may be significant traffic migration away from the PSTN resulting in an increase in the per-minute call conveyance cost, nonetheless, the Commission expected that the call conveyance cost would remain below 1 cent per minute for the foreseeable future.

The Commission has assessed the extent to which volumes on the PSTN have altered from those that the Commission took into account in 2003 to arrive at its indicative prices at that time. Based on information provided as part of Telstra's Regulatory Accounting Framework (RAF), the Commission considers that there has been approximately an 18 per cent reduction in PSTN traffic volumes over that period. A resulting indicative price for PSTN OTA using the Commission's 2003 estimate of conveyance cost as a starting point and the volume information derived from the RAF would therefore be in the order of 0.83 cents per minute for 2006-07.

The Commission has also examined the costs of PSTN conveyance as presented in Telstra's latest RAF reports to arrive at a possible 2006-07 indicative price for PSTN OTA. The Commission's analysis suggests that the unit cost of PSTN OTA using the latest available RAF data is in the order of 0.96 cents per minute.

In response to the Commission's draft indicative prices Optus and the CCC argued that there was an expectation by industry, based on the Commission's views in 2003, that indicative prices for 2006-07 would have fallen to 0.7 cents per minute. As a result, the CCC argues that the industry has priced into its forward cost estimates a price of 0.7 cents per minute for PSTN OTA.

The Commission notes that it had expressly stated in 2003 that it was not providing an indicative price for 2006-07 because of the uncertainties and risks associated with forecasting future costs and traffic volumes. The qualified statements made in the 2003 report in respect to 2006-07 indicative pricing would suggest that basing forward business plans on a PSTN OTA price of 0.7 cents in 2006-07 would represent a risky strategy.

As indicated above, the Commission now has available more current traffic volume information as well as current RAF cost information on which to calculate indicative prices for 2006-07.

Based on the analysis undertaken and the fact that the indicative PSTN OTA price for 2005-06 was 1 cent per minute, the Commission considers that it would be appropriate to maintain the PSTN OTA indicative headline rate for 2006-07 at 1 cent per minute. Given the ongoing work that is being undertaken in relation to the establishment of efficient PSTN OTA costs, the Commission believes that this price-related term and condition under section 152AQA(2) will, in the interim, provide a useful starting point for commercial negotiations between access providers and access seekers.

In the draft report the Commission also sought comment on proposed disaggregated flagfall and per-minute charges for various geographic areas.

In response to the draft disaggregated charges proposed by the Commission, Optus commented that it considered that the proposed disaggregation of the headline indicative PSTN OTA price raised a number of concerns. In particular Optus stated that:

- The price table has an unreasonably high flagfall component that is not justified by reference to the underlying cost drivers. This high flagfall component means that charges are very sensitive to differences in the pattern of call hold-times between different carriers.
- The PIE II model, on which the disaggregation is based, significantly overstates the costs of rural services which results in an overstatement of rural prices in the proposed pricing table.

Optus also commented that it is no longer clear that the proposed price structure actually reflects current assumptions about traffic patterns (such as call volumes and call hold-times) on which this structure was based.

The Commission notes that, as already indicated, indicative prices are designed to provide a starting point for commercial negotiations or arbitration by the Commission. Prices established either through commercial negotiation or arbitration will reflect the specific characteristics (in terms of call holding times and traffic profiles) of the carriers involved. Also, again as already indicated, these indicative prices are designed to provide some interim guidance on PSTN OTA pricing while more detailed work is undertaken to assess the underlying costs of the PSTN and of the breakdown of those costs between different geographic areas.

The Commission has, therefore, decided to maintain the disaggregated flagfall and per-minute charges in various geographic areas as set out in the draft indicative prices report. These disaggregated charges are consistent with those established in the 2003 Determination and are set out in Part 2 of Schedule 3 to the instrument annexed in Appendix B.

Chapter 6 Local Call Override

In submissions in response to the *Local Services Review: Final Decision* and the *Declaration Inquiry for the ULLS, PSTN OTA and CLLS: Final Determination* Telstra lodged a submission in which it argued that the Commission should address the local call override (LCO) issue. LCO involves what Telstra considers is access seekers' inappropriate use of the PSTN OTA services to originate and terminate local calls (using a prefixed override code). This allows access seekers to accrue charges for local calls at the PSTN OTA per minute rate instead of the higher LCS rate. As such, local call override may be attractive in the case of short duration local calls. However, the local call override generally represents an inefficient use of network infrastructure as it often uses more network elements that are necessary to efficiently convey a local call.

The Commission received submissions from the Competitive Carriers Coalition and Optus that argued against Telstra's proposal to prevent access seekers using LCO.

Telstra has provided insufficient information for the Commission to make an assessment of its magnitude of its claims in respect of the LCO. In any event, the Commission considers that it is not appropriate to deal with this issue as part of the pricing principles. Rather, it is more appropriately dealt with through commercial negotiation and, if necessary, in an arbitration process conducted by the Commission.

Appendix A: Submissions received

Competitive Carriers Coalition	August 2006 November 2006
Frontier Economics (on behalf of the Competitive Carriers Coalition)	August 2006
Telstra	11 September 2006 9 November 2006
Optus	1 September 2006

Appendix B

TRADE PRACTICES ACT 1974

Section 152AQA

Pricing principles for the Local Carriage Service, Wholesale Line Rental Service and Public Switched Telephone Originating and Terminating Access Services

The Australian Competition and Consumer Commission determines, pursuant to section 152AQA of the *Trade Practices Act 1974* (the Act), that the pricing principles and price-related terms and conditions specified in the Schedules are to apply to the following services declared by the Commission under section 152AL of the Act:

(a) the Local Carriage Service;

(b) the Wholesale Line Rental Service; and

(c) the Public Switched Telephone Originating and Terminating Access Services

Note: For the effect of this determination, see subsection 152AQA(6) of the Act.

Made by the Australian Competition
and Consumer Commission on
22 November 2006

Graeme Samuel
Chairman

SCHEDULE 1 – Local Carriage Service (LCS)

Part 1 – Pricing Principles

An interim retail-minus-retail-costs (“RMRC”) pricing principle should be adopted until such time as the Commission has a robust cost model available. In implementing the interim RMRC pricing principle, the Commission will use:

- avoidable retail costs for the LCS rather than avoided retail costs
- unbundled benchmark retail prices
- separate pricing of the LCS.

The Commission will seek to implement a cost-based pricing approach once a robust cost model, capable of producing reliable estimates of costs in all geographic regions, is available.

Part 2 – Price-related terms and conditions

	Local Calls
Telstra Retail Prices	20c ex GST
Unit Avoidable Retail Costs	2.29c/call
GST Adjustment	0.21c
Indicative Price	17.92c

SCHEDULE 2 – Wholesale Line Rental Service (WLR)

Part 1 – Pricing Principles

An interim retail-minus-retail-costs ("RMRC") pricing principle should be adopted until such time as the Commission has a robust cost model available. In implementing the interim RMRC pricing principle, the Commission will use:

- avoidable retail costs for the WLR rather than avoided retail costs
- unbundled benchmark retail prices
- separate pricing of the WLR.

The Commission will seek to implement a cost-based pricing approach once a robust cost model, capable of producing reliable estimates of costs in all geographic regions, is available.

Part 2 – Price-related terms and conditions

	HomeLine Part	**BusinessLine Part**
Telstra Retail Prices	$29.05	$31.77
Unit Avoidable Retail Costs	$5.93/mth	$5.93/mth
Indicative Price	$23.12	$25.84

SCHEDULE 3 – Public Switched Telephone Originating and Terminating Access Services (PSTN OTA)

Part 1 – Pricing Principles

The price of the PSTN OTA Service should be determined on the basis of total service long run incremental cost (“TSLRIC”).

Part 2 – Price-related terms and conditions

Disaggregated indicative prices for PSTN OTA services in 2006-07

2006-07	*Flagfall*	*EMOU charge*	*Headline rate*
CBD	0.85	0.35	0.57
Metropolitan	0.84	0.49	0.70
Provincial	0.94	0.68	0.91
Rural	2.06	3.66	4.18
Average	**0.95**	**0.76**	**1.00**