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Review of the 1997 telecommunications access pricing principles for fixed line services

1. Introduction

Macquarie Telecom Pty Limited ("**Macquarie**") welcomes the opportunity to make this submission to the Australian Competition and Consumer Commission ("**ACCC**"). This submission is in response to the ACCC's draft report concerning the above. [1]

Macquarie appreciates the work that the ACCC has undertaken in its review of its approach for setting prices for fixed line services. This is an inherently complex task and its outcome will have a direct impact on competition in fixed line services. The ACCC's key proposal is to shift to a building block model ("**BBM**") pricing approach.

The "bottom line" to the Draft Report is proposed reductions in indicative prices for the WLR and LCS while the indicative prices for the other declared fixed line services are effectively unchanged. Macquarie welcomes these proposed price reductions because they are conducive to promoting competition in fixed line services. However, Macquarie reiterates its view that the key to effective competition in fixed line services is reform to industry structure. That is, the need for a complex fixed line service access and pricing regime would be obviated if Telstra was structurally (or functionally) separate.

Apart from this introduction, this submission is structured in two main parts. The first responds to those specific matters raised in the Draft Report on which the ACCC has sought views from industry. The second part comments on those matters on which the ACCC has formed a view and which Macquarie believes are significant and as such warrant comment.

2. Responses to Specific Matters

The Draft Report raises several specific matters upon which industry comment is sought. In this section, relevant extracts from the Draft Report are reproduced in *italics* followed by Macquarie's response.

[1] ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services, Draft report, September 2010 ("**Draft Report**")

2.1 Two-stage Transition Period

Given the continuing high level of uncertainty around the communications environment and the legislative framework for telecommunications, industry comment is sought on whether a two-stage transition period may be appropriate. (Draft Report page 52)

The ACCC has sought industry comment on the appropriateness of a two-stage transition period in the context of whether it is desirable to move from de-averaged to averaged ULLS prices. The Draft Report sets de-averaged ULLS prices for the period to 31 December 2014 with a view to reassessing whether disaggregated ULLS prices are appropriate after this date.

Whether ULLS prices should be averaged or de-averaged has been widely debated. In Macquarie's view, de-averaged ULLS prices are appropriate. This is because the costs of providing the ULLS varies significantly across geographies and the fact that ULLS services are seldom offered in rural areas. As such, averaged ULLS pricing would not be cost reflective and a move to averaged ULLS prices would be detrimental to competition in CBD and metropolitan areas as prices would increase substantially in such areas. Moreover, ULLS averaging will not promote competitive entry and competition in regional areas (bands 3 and 4). This is because the key barrier to entry in these areas is not ULLS prices but line-length limitations and backhaul prices (perhaps enhanced by Telstra's averaging of retail broadband and telephony prices across high and low cost areas).

Macquarie has no objection in principle to a further reassessment of whether averaged ULLS prices might be appropriate in the period following 31 December 2014. However, Macquarie contends that the reasons supporting de-averaged ULLS pricing today will still be relevant and appropriate in four years' time. Accordingly, Macquarie sees little value in committing to such a review at this time.

2.2 PSTN OTA Pricing Structure

Industry comment is also sought on whether the existing structure for PSTN OTA prices is appropriate. (Draft Report page 52). The ACCC seeks submissions on the disaggregated rates consistent with the headline rate of 1.1 cent. (Draft Report page 104).

The existing structure of PSTN OTA pricing has four geographic bands and a "headline" or average price based on the relative volume of traffic across the four bands. There is a large disparity between the lowest price (0.63 cents) and the highest price (4.6 cents) across the four bands. It is Macquarie's belief that the disaggregated pricing structure is beneficial to competition as it has enabled competitors to match the pricing of end user services to the underlying cost of their provision. As such, Macquarie believes that the current disaggregated pricing structure for PSTN OTA is appropriate.

Macquarie is, however, concerned that the ACCC proposes to increase the headline price by 10 *per cent* from 1 to 1.1 cents. This appears to be due to a steep forecast decline in PSTN OTA volume over the estimation period. (Refer to discussion in section 3.3.4). In addition, it would appear that the reduction in PSTN OTA volume reflects a loss of traffic through competition. That is, the substantial increase in ULLS volume would result in a shift of PSTN OTA volume from Telstra to competing operators. In Macquarie's view, it is unfair for Telstra to be awarded a price increase for losing traffic to competitors and unfair for competitors to be hit with a price increase as their "reward" for being effective competitors. Accordingly, Macquarie urges the ACCC to reconsider its proposed PSTN OTA indicative price with a view to a downward revision.

2.3 PSTN Origination and Termination Pricing Symmetry

Submissions are also sought on whether prices for PSTN originating access services should be the same as those for PSTN terminating access services, noting that the assets used to provide these services are identical. In the absence of industry views to the contrary, the ACCC's preliminary view is that these prices should remain the same. (Draft Report page 52)

Macquarie notes that PSTN call origination and PSTN call termination are fundamentally different processes, i.e., one cannot be substituted for the other. However, each process uses the same underlying CAN assets.

It is a widely accepted practice in markets around the world that the charges for call termination and call origination are the same. This practice simplifies pricing structures and removes any economic incentives for operators to promote one service over the other. Accordingly, Macquarie sees no grounds for moving to a differential pricing structure and as such supports the ACCC's preliminary view that the prices for PSTN termination and PSTN origination should be the same.

2.4 Cost Allocation Factors

The ACCC considered whether an adjustment was needed to the cost allocation factors for LCS. Given that the share of switching equipment allocated to LCS in the Analysys model is relatively low, the ACCC considered that any adjustment to the factors for LCS would be minor and it concluded that no adjustment would be made. Submissions are sought on the appropriateness of this conclusion. (Draft Report page 93)

The impact on the cost allocation factors for other Core assets is not expected to be significant although the ACCC seeks submissions on this issue. (Draft Report page 93)

The ACCC's approach to setting cost allocation factors which are used to allocate costs to services is based on the cost allocation factors used in the Analysys Cost Model. The ACCC has then adjusted these cost allocation factors to reflect more current information. Such adjustments reflect the ACCC's consideration of:

- "de-optimising" the optimisation undertaken by Analysys; and
- changing patterns of fixed line service demand.

Macquarie is concerned about the absence of transparency and the *ad hoc* nature of the adjustments that the ACCC has made to the Analysys cost allocation factors. The cost allocation factors are not directly linked to changes in demand for different types of services, and the ACCC has tried to adjust allocation factors in preference to reducing legacy costs. Macquarie believes that the ACCC should be fully transparent in how it has allocated costs and that the cost allocation factors should be determined using parameters fully specified within its cost model.

3. Comments on Significant Matters

The ACCC has set out its views on a wide range of matters in the Draft Report which collectively frame its proposed approach to setting indicative prices for the declared fixed line services. In this section, Macquarie has commented on what it believes to be significant matters and which warrant comment.

3.1 Valuation of the initial RAB

The ACCC proposes to adopt the cost-based depreciated actual cost ("**DAC**") valuation method for setting the valuation of the initial RAB. The choice of valuation method inevitably involves an assessment of the relative merits of alternative valuation methodologies. The key alternatives to DAC are:

- optimized replacement cost ("**ORC**"); and
- depreciated optimized replacement cost ("**DORC**").

The ACCC currently applies ORC for pricing fixed line services. It is widely recognised that there are significant problems with ORC. DORC also suffers many problems which are primarily hereditary as a result of DORC being created from ORC. Macquarie believes that DAC by contrast is relatively simple, objectively measured and is well understood. Accordingly, Macquarie supports the ACCC's intention to adopt DAC to set an opening RAB.

The ACCC proposes an initial RAB of $7.5 billion for CAN assets and $5.8 billion for Core assets. These values are taken from regulatory accounting framework ("**RAF**") data provided to the ACCC by Telstra. Macquarie understands that the RAF accounts are prepared on the basis of historical cost accounting which is entirely consistent with the DAC valuation method. Information provided to the ACCC under the RAF should be considered accurate and reliable.

Macquarie does, however, note that the ACCC has not made any adjustment for over or under recovery of the access provider's past compensation. This is limited to straight line depreciation. Leaving aside the difficulty of measurement, it would seem likely that Telstra would have recovered more than straight line depreciation suggesting that a lower initial RAB valuation should be adopted.

On balance, Macquarie supports the ACCC's proposal to set the opening RAB using the RAF values. In doing so, the ACCC must recognise that this is a conservative approach which favours Telstra.

3.2 Depreciation Method

The ACCC proposes to adopt a straight line depreciation schedule under its proposed fixed line service costing approach.

The approach for addressing how past compensation should be taken into account must be consistent with the asset valuation approach which is used to set an opening RAB. Depreciation could be front loaded (more favourable to Telstra), back loaded (more favourable to access seekers) or straight line. Macquarie supports the ACCC's choice of the straight line approach to depreciation as this approach:

- is consistent with the DAC as the RAB valuation approach;
- effectively balances the opposing interests of access seekers and Telstra; and
- is the simplest approach to adopt.

3.3 Forecasts

In the absence of data provided by Telstra, the ACCC has made its own forecasts of the following items:

- capital expenditure on assets used to provide fixed line services (Appendix A3);
- operating and maintenance expenditure related to assets used to provide fixed line services (Appendix A4); and
- demand for fixed line services (Appendix A8).

Macquarie appreciates that fact that the ACCC has taken the decision to make its own forecasts in the absence of Telstra's input. It is appropriate for the ACCC to do this because the critical task of setting indicative prices for fixed line services is too important for it to be dictated to by Telstra. In a BBM pricing approach, Telstra will have strong incentives to under-forecast demand and over-forecast costs. *Ceteris paribus* this results in higher indicative fixed line service prices and Telstra will be able to keep any gains arising until the start of the next price control period. This situation can be avoided if the ACCC makes its own forecasts or, if it wants Telstra to do them, the ACCC must place Telstra under a lot of scrutiny (as occurs in other industries like gas and electricity).

Macquarie's comments on the above forecast items are given below.

3.3.1 Capital Expenditure

The ACCC has made the assumption that the capital expenditure over the estimation period will be approximately equal to the five year average of real past capital expenditure on the CAN and Core as reported in Telstra's annual reports.

Macquarie makes the following comments on the ACCC's capital expenditure forecasts:

- it is appropriate for the ACCC to forecast Telstra's capital expenditure in the absence of such information being available from Telstra;
- actual capital expenditures as reported by Telstra in its annual reports should be considered accurate and reliable;
- capital expenditure on both CAN and Core assets has fallen in the previous two years which suggests that the five year average is excessive; and
- it would seem unlikely that Telstra would continue to invest in fixed network assets to the same extent that it has in past years given the inevitable switch to NBN infrastructure.

In the light of these comments, Macquarie, believes that an alternative forecast based on the continuation of capital expenditure on the CAN and Core assets at real current levels would better capture the likely outlook for Telstra's capital expenditure in the estimation period. This would result in forecasts for annual capital expenditure on CAN and Core assets of $550 million and $730 million respectively instead of $750 million and $1,100 million as proposed by the ACCC.

3.3.2 Operating Expenditure

The ACCC has forecast Telstra's operating expenditure over the forecast period as the average actual operating and maintenance expenditures over the past five years as provided by Telstra to the ACCC as part of the RAF. In addition, the ACCC has increased the RAF values by 10 *per cent* to reflect an allocation of corporate overhead and has made the specific assumption that Telstra's past operating expenditure reflects "an efficient level of expenditure."[2] The actual forecasts are not provided as they are considered to be commercial in confidence.

Macquarie makes the following comments on the ACCC's forecast of operating expenditure:

- it is appropriate for the ACCC to forecast Telstra's operating expenditure in the absence of such information being available from Telstra;
- actual operating expenditures as reported by Telstra as part of the RAF should be considered accurate and reliable;
- Telstra's historical operating expenditures and the ACCC's forecasts of Telstra's operating expenditure should be publicly disclosed to enable more rigorous scrutiny;
- the ACCC has not provided an explanation for increasing the RAF values by 10 *per cent*;
- the assumption that Telstra's past expenditure is "efficient" would appear to be very generous. For example, Telstra has recently announced "Project New" which aims to reduce spending on external suppliers, improve customer service and field workforce productivity, simplify prices and reduce the company's ongoing costs [3]; and
- overall, the ACCC's forecasts of Telstra's operating expenditure appear to be overstated.

In the light of these comments, Macquarie believes that the ACCC should revisit its forecasts of Telstra's operating expenditure with a view to a downward revision.

3.3.4 Demand for Services

The ACCC has forecast demand for the ULLS, WLR, PSTN OTA and LCS services. For the ULLS the ACCC has taken ULLS usage data from the CAN RKR and has estimated that recent substantial growth rates will decline over the estimation period. For the WLR, the ACCC has taken usage data from Telstra's 2009-10 annual report and forecast that demand will decline at a reducing level over the estimation period. Driving these forecasts is the conversion of WLR lines to ULLS lines.

In respect of PSTN OTA, the ACCC has taken PSTN OTA usage from the RAF and made a forecast on the basis of the rate of substitution from fixed to mobile voice services. The reduction in PSTN OTA is 10 *per cent* in the first year followed by 8 *per cent per annum* thereafter. For the LCS, the ACCC has estimated the current demand from RAF data and then applied the same annual rates of decline as per the PSTN OTA.

Macquarie makes the following comments on the ACCC's forecast of service demand:

- it is appropriate for the ACCC to forecast the demand for fixed service in the absence of guidance from Telstra;
- the rate of declining growth in demand for the ULLS seems aggressive given the investment that competing operators have already made in exchange equipment and their desire to utilise this investment;

[2] Draft Report, page 81
[3] Telstra, Telstra details strategy as sales momentum builds, Media Release, 29 September 2010

- the decline in WLR demand at a reducing level is aggressive given the reduction in the indicative price of the WLR which is proposed in the Draft Report, i.e., a lower WLR price would be expected *ceteris paribus* to stimulate demand for this service;
- the forecast reduction in PSTN OTA and LCS demand appears to be excessive. The ACCC assumes that demand for these services will fall by around 30 *per cent* over the estimation period. Macquarie notes, for example, that it is reported that the number of fixed lines in Australia has declined by only 1.8 *per cent per annum* in the five years to 2010-11.[4] While further reduction in the number of fixed lines is expected, this does not seem sufficient to support the dramatic reduction in PSTN OTA that the ACCC has forecast.
- the ACCC's assumption that the forecast decline in LCS should follow that of PSTN OTA is not explained.

Given these comments, Macquarie believes that the ACCC should revisit its fixed line service demand forecasts with a view to their upward revision.

3.4 Proposed Record Keeping Rule

The ACCC proposes to make a record keeping rule ("**RKR**") to obtain forecast capital expenditure and operating expenditure and service demand information from Telstra and will undertake a separate consultation process as appropriate. The need for such an RKR arises because Telstra has been unable to provide sufficient information to the ACCC concerning its forecast capital expenditure and operating expenditure and service demand information as is necessary for the ACCC to set indicative prices for fixed line services using its proposed BBM pricing methodology.

Macquarie believes that it is entirely appropriate that the ACCC formalises its forecast information requirement from Telstra in an RKR. Such information is a key input to the ACCC's critical task of setting indicative prices for fixed line services. Accordingly, Telstra should not be allowed any discretion in providing this information. As such, Macquarie strongly supports the ACCC's intention to make an RKR to obtain relevant forecast information from Telstra. Macquarie looks forward to participating in the ACCC's consultation process on this matter.

3.5 Length of Regulatory Period

The ACCC proposes to have an initial regulatory period of four years.

Macquarie recognises that setting an appropriate length of time between reviewing regulated prices must balance the need for certainty and administrative efficiency with the reality that the telecommunications sector is dynamic and that the future is inherently uncertain. Macquarie believes that the initial regulatory period must be sufficient to provide access seekers with input pricing certainty to provide an investment incentive and to minimize the administrative burden of pricing reviews. In Macquarie's view the initial regulatory period must be at least four years to satisfy these requirements.

In the current situation, Macquarie is concerned about the reasonableness of the ACCC's cost and demand forecasts and the absence of transparency on their derivation which *prima facie* favour Telstra. Accordingly, Macquarie supports the ACCC's proposal to have an initial regulatory period of four years subject to the proviso that it can be satisfied that the ACCC's forecasts are reasonable.

[4] IBISWorld, Communication breakdown or breakthrough? 6 October 2010

3.6 Review During Regulatory Period

The ACCC considers that there should be scope for a review of a Pricing Principles Determination within a regulatory period only if there are exceptional circumstances that warrant such a review. Such review may be requested by an access seeker or an access provider and any such request for review would itself be subject to public consultation. The ACCC may also initiative a review of a Pricing Principles Determination.

Macquarie is of the view that a review of a Pricing Principles Determination within a regulatory period should occur only in exceptional circumstances and as such supports the ACCC's proposal. A high review threshold is necessary to meet the requirement of pricing certainty. If prices are readily open to review such certainty is devalued.

3.7 Link Between Cost Models and Indicative Prices

The ACCC has used cost models to inform its view of indicative prices for fixed line services. Specifically, Ovum has developed for the ACCC a cost model to measure the costs of ULLS, WLR, PSTN OTA and LCS. A separate incremental cost model has been used to measure the costs for LSS.

Macquarie is concerned that there is a significant gap between the outputs of the cost models and the ACCC's draft indicative prices. While Macquarie accepts that there is room for the ACCC to exercise a degree of discretion in departing from the cost model outputs, the gap for each service is both significant and favourable to Telstra. Of particular concern is the case of the LSS. Despite this very point being addressed in the ACCC's Questions and Answers [5] concerning this review, Macquarie remains unconvinced that the ACCC's view that the indicative price for the LSS should remain at $2.50 is justified.

3.8 WACC

Macquarie notes that the Draft Report sets out a detailed explanation of the derivation of the WACC used by the ACCC to set draft indicative prices. This is despite the ACCC not requesting input on this matter. Macquarie is of the view that the ACCC's derivation of the WACC is consistent with current practice of the ACCC and the Australian Energy Regulator and to this extent supports the ACCC's view of WACC as set out in the Draft Report.

4. Summary and Closing

Macquarie welcomes the ACCC's review of the access pricing principles for fixed line services. The shift to a "building block" pricing approach as is proposed is more appropriate for the pricing of these services particularly as it removes the requirement to revalue the asset base every time that there is a pricing review.

Macquarie supports the broad approach that the ACCC has taken to the pricing of fixed line services. However, there are some areas in which Macquarie believes that the application of the ACCC's pricing approach may be improved. In particular:

- the ACCC should revisit its forecast of Telstra's capital expenditure and operating expenditure with a view to a downward revision;

[5] ACCC, Questions and Answers Fixed Line Services Pricing Review Draft Report, 14 October 2010

- the ACCC should revisit its forecasts of fixed line service demand with a view to an upward revision; and
- the ACCC should place greater weight on the outputs of its cost models in setting draft indicative prices for fixed line services.

Macquarie would welcome an opportunity to discuss the detail of this submission with you. Should you have any queries please do not hesitate to contact me.

Yours sincerely

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