



REVIEW OF ACCESS PRICING PRINCIPLES FOR FIXED LINE SERVICES

Submission to the
Australian Competition
and Consumer Commission

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Contents

1. Introduction	2
1.1 Moving from TSLRIC+ to BBM	3
1.2 Promoting the long-term interest of end-users	4
2. Setting the initial RAB	6
3. Determining the revenue requirement	7
3.1 Depreciation method	7
3.2 Cost of capital	8
3.3 Capital expenditure, operating expenditure and efficiency mechanisms	9
4. Setting prices for specific services	10

1. Introduction

Vodafone Hutchison Australia Pty Limited (**VHA**) welcomes the opportunity to comment on the Australian Competition and Consumer Commission's (**ACCC**) draft report, which sets out its proposed approach to the access pricing principles to apply to the declared fixed line services from 1 January 2011 to 31 December 2014 (**Draft Pricing Principles**). VHA is a member of the Competitive Carriers Coalition (**CCC**) and is supportive of its submission on this matter.

The network services that comprise the key wholesale and access services delivered over Telstra's copper and fibre Consumer Access Networks (**CAN**) are:

- > unconditioned local loop services (**ULLS**);
- > wholesale line rental (**WLR**);
- > line sharing service (**LSS**);
- > public switch telephone network originating access (**PSTN OA**)
- > public switch telephone network terminating access (**PSTN TA**); and
- > local carriage service (**LCS**).

The ACCC determines pricing principles and indicative prices for each of these declared fixed line services.

Some of the declared services – the LCS, PSTN OA, PSTN TA and WLR – are relevant to the delivery of, or interconnection to, fixed voice services. Of direct relevance to VHA are the PSTN OA and TA services, which impact both mobile phone to fixed network calls and fixed network to mobile network calls. VHA is an access seeker with respect to PSTN TA services.

The regulated prices of Telstra's other fixed voice services should reflect sound economic principles. While VHA regards fixed line services as largely providing a complement to mobile services, pricing principles that fail to provide incentives for the economically efficient use of fixed line infrastructure may have unintended consequences on the mobile services market. We note that wholesale services such as the LCS or the WLR service are used as inputs into services that compete, at least in part, with the mobile voice services offered by VHA.

Fixed broadband services can be delivered over Telstra's copper line via an unbundled line (that is, either ULLS or LSS) plus the access seekers own infrastructure in the exchange building, or by reselling wholesale broadband from Telstra or another access seeker. VHA regards its mobile broadband services as largely a complement to fixed broadband services.

VHA understands that the Draft Pricing Principles are not intended to apply to any services supplied over the National Broadband Network (**NBN**). Further, we note that the ACCC may develop separate pricing principles for services such as the mobile terminating access service (**MTAS**) and the domestic transmission capacity service (**DTCS**). VHA observes that the optimal approach to regulating natural monopoly infrastructure (for example, fixed line services) is likely to be different to the optimal approach to regulating competitive (or contestable) infrastructure markets (for example, the mobile terminating access service). However, there is merit in ensuring that services with similar characteristics are regulated in a similar manner. In that context, VHA notes its support for a transition to the Building Block Model (**BBM**) in setting pricing principles for the DTCS.¹

¹ For more information see: VHA (2010), *Pricing of the Domestic Transmission Capacity Service* Submission to the ACCC, July.

1.1 Moving from TSLRIC+ to BBM

VHA supports the ACCC's move from Total Service Long-Run Incremental Cost 'plus' (**TSLRIC+**)² approach to the Building Block Model (**BBM**) for fixed line services. The ACCC's historic approach to determining pricing principles has contributed to complexity and uncertainty for both access seekers and access providers. The move to a BBM for fixed line services is a welcome step, and will promote regulatory certainty. Before considering the transition BBM it is necessary to understand the problems of the previous approach to avoid repeating the mistakes of the past.

The fundamental problem with the previous approach arose from the ACCC's misguided attempts to influence the build/buy decision. While we agree with the promotion of efficient build/buy signals, the previous pricing principles for fixed line services did not provide appropriate build/buy signals. The ACCC's was driven by a view "that valuing the sunk assets at their actual/historic cost would encourage access seekers to build their own infrastructure, when it would actually be more efficient for them to buy access to the existing infrastructure".³ The argument assumes it is necessary for the ACCC to take steps to deter so-called "inefficient bypass". However, the access provider should already have sufficient commercial incentives to avoid bypass. The ACCC also appears to have previously ignored the corresponding impact on the 'build' decision, where risk of ex-post

The issues arising from the ACCC's approach to build/buy decision were compounded by its interpretation of the principle of 'forward-looking costs'. This led to the ACCC's approach of periodically 'optimising' and the revaluing the fixed line assets used to provide access services. Its approach was based on a misplaced assumption about that the costs of replacing components of the telecommunications network – for example, ducts and pipes, and trenching – would decrease. In fact, these costs increased. As a consequence, there is a significant risk that the access provider, in this case Telstra, may have been permitted to over-recover the costs associated with building its fixed line network.

By itself, the transition to BBM is not sufficient to guarantee better regulatory outcomes for fixed line services. For instance, the concept of optimised replacement costs (**ORC**) is not specific to the TSLRIC+ approach; ill-considered periodic revaluations of the Regulatory Asset Base (**RAB**) could involve some form of optimisation using modern equivalent assets. For that reason, the ACCC must adopt the principle of Financial Capital Maintenance (**FCM**).⁴ Measures such as locking-in and rolling-forward the RAB are arguably the simplest and most effective means of ensuring FCM. Such measures are essential if the BBM is to promote the long-term interest of end-users. The ACCC cannot permit over- or, indeed, under-recovery of the capital costs associated with the provision of Telstra's fixed line infrastructure.

The ACCC's decision to adopt a 'scorched node' approach in modelling the cost of a replacement was not a deficiency of the TSLRIC+ approach. It is appropriate to retain the existing location of certain key features of the access provider's existing network, such as local exchanges or other major points of confluence, while optimising other components of the network including most notably the routes between and within nodes. The scorched-node approach to use historical number and placement of nodes helps to ground the TSLRIC+

² Where 'plus' refers to an appropriate mark-up to ensure the efficient recovery of joint and common costs.

³ ACCC (2009), *National Broadband Network: Regulatory reform for the 21st century*, Submission to DBCDE, p115.

⁴ FCM refers to the fact that the initial 'financial capital' is maintained through time. In technical terms, FCM requires that the Net Present Value (NPV) of any expected compensation for the access provider should be zero (NPV=0) factoring in the initial value of the asset and a discount rate equal to their cost of capital. That is, the present value of compensation over time net of the initial costing of the asset is equal to zero (for an asset with an initial costing of \$100, the required level of future revenues must be equal to \$100 when discounted to the timing of the initial costing).

model in reality – that is, reflecting the actual network deployed by Telstra. Further, it is appropriate as it seems unlikely that Telstra's would have used a highly inefficient network topology in deploying key elements of its network infrastructure.

The scorched-node approach requires the model to be calibrated to ensure, for instance, node counts correspond with reality. This ensures that that level of assets in the model is not underestimated due to factors that are not explicitly modelled (such as network topology). It is reasonable to consider network optimisation as part of a TSLRIC+ approach, as Analysys Mason previously did in its LRIC model of Telstra's network, to ensure the network equipment installed at each node location reflects the busy-hour requirements of the network.

The scorched earth approach usually makes use of network planning tools based on theoretical efficiency, but with little grounding in the issues of practical network deployment. Such tools run the risk of significantly underestimating what an efficient actual network deployment would be, and therefore provide little scope for the access provider to recover their efficiently incurred costs. This is particularly the case where networks have evolved to meet the growing needs of a country's residents and businesses through, for instance, the development and construction of homes in a greenfield estate. In such circumstances, the efficient extension of fixed line infrastructure to the new homes from existing exchanges may not reflect ex-post network optimisation but it does constitute prudently incurred expenditure.

The ACCC's observation that the scorched node approach "is likely to have generated higher estimates of TSLRIC+, and has higher access prices, than would have been obtained with a scorched earth approach" is factually correct, but meaningless within the context of promoting the long-term interests of end-users. The scorched earth approach reflects a pernicious form of hindsight bias. It risks leaving prudently incurred expenditure stranded, creating a significant deterrent to economically efficient investment in infrastructure for the access provider. The distortion to price signals derived from scorched earth approaches is likely to deter efficient entry in circumstances where competitive infrastructure deployment might otherwise be contemplated. The proposed BBM approach locks-in the RAB, thereby removing the poor incentives created by the periodic optimisation of the fixed line network.

The BBM approach will not overcome all the deficiencies of the previous approach. Its strength is that it is simple to understand, straightforward to implement and it provides good incentives for the access provider to pursue efficiency. However, while the BBM approach does not require the ACCC to consider network design to the same extent as TSLRIC+, it will require the ACCC to undertake detailed investigation of Telstra's investment plans. The BBM approach is susceptible to information asymmetries between the regulator and the access provider. To that end, it will be necessary for the ACCC to consider a somewhat intrusive approach to its assessment of Telstra's infrastructure investments if it is to ensure that only prudent capital expenditure is rolled-in to the RAB.

1.2 Promoting the long-term interest of end-users

The ACCC has significant regulatory discretion regarding the matters it must consider in making its Pricing Principles Determinations for access to declared services. We agree that the discretion should be exercised with regard to the object of Part XIC of the *Trade Practices Act 1974 (TPA)*, which is to promote the long-term interest of end-users (LTIE) of carriage services or services provided by means of carriage services. The TPA further states that for the purposes of determining whether a particular thing promotes the LTIE, regard must be had to the extent to which the thing is likely to result in the achievement of the following objectives:

- > promoting competition in markets for listed services;
- > achieving any-to-any connectivity in relation to carriage services that involve communication between end-users;
- > encouraging the economically efficient use of, and the economically efficient investment in the infrastructure by which listed services are supplied or any other infrastructure by which listed services are capable of being supplied.

In considering how the transition to the BBM approach is likely to prove more effective at promoting the LTIE, it is necessary to consider the potential deficiencies of the previous approach in meeting the LTIE. As previously noted, the network 'optimisation' associated with the

previous TSLRIC+ approach may have led to cost over-recovery as input and asset prices (unexpectedly) increased after Telstra's fixed line assets were re-valued. This led to higher indicative prices for fixed line access and wholesale services than might be expected if costs had been based on the depreciated actual cost (DAC) of the network. Other problems arose from the complexity of the TSLRIC+ approach and, in particular, the challenges for access seekers and, to a lesser extent, Telstra in assessing the theoretical network optimisation. As a consequence, access seekers had little transparency or certainty with respect to the direction of the ACCC's indicative prices for fixed line services. For these reasons, we agree with the ACCC that the desirable features of pricing principles for fixed line services are likely to include:

- > a fair rate of return on investment (cost recovery);
- > incentives for efficiency and innovation; and
- > transparency and regulatory certainty.

The approach to access pricing must be cost-based and consistent with the principle of FCM. This will ensure that the access provider neither under- nor over-recovers the efficient costs of providing access to regulated services. The access provider should only be permitted to recover its legitimate costs and earn a rate of return commensurate with the risk of its investments. Emphasis on cost recovery is essential to encourage economically efficient investment in infrastructure. In particular, it provides greater certainty of a fair rate of return for access providers and ensures access seekers are provided with appropriate price signals so as to consider their build/buy decision.

A well-understood incentive framework is one of the primary reasons to transition to a BBM approach. VHA supports the use of incentives for the access provider to reduce costs or to improve productivity. In practice, regulatory mechanisms that provide incentives are usually based on the scope for short-term cost over-recovery by access providers. Therefore, such incentives must be transparent and require strong regulatory oversight to prevent 'gaming'. We note that regulators in other industries and jurisdictions have proposed incentive mechanisms that reduce the scope for gaming opportunities.⁵

In our view, the primary concern with respect to the structure of access and wholesale prices is the capacity of a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations. Even if Telstra was constrained in its overall prices for access services it will have an incentive to allocate costs to access services and in geographic areas in areas where it face more intense competition. If Telstra can raise the access price for services where it faces more competition it could discourage its competitors from competing vigorously, or worse foreclose its competitors from serving important customers damaging their ability to compete in the market as a whole. The ACCC must be mindful that Telstra's incentive to damage competition in the downstream market is likely to dominate the regulatory mechanisms designed to encourage economically efficient use of infrastructure.

We acknowledge the ACCC's reference to other aspects of the structure of access prices. While features such as multi-part pricing and price discrimination may, in certain circumstances, improve economic efficiency, it is difficult to make general statements about the desirability of such features within the context of the ACCC's Pricing Principles. Such features will typically add to the computational complexity of determining cost-based indicative prices for fixed line services. Complex Pricing Principles necessarily increase the prospect

⁵ See for example the "sliding scale matrix" implemented by Ofgem (available at <http://www.ofgem.gov.uk/Markets/RetMkts/Metmg/Metering/Documents/1/8944-26504.pdf>) or the "menu regulation proposal" from Ofwat (available at http://www.ofwat.gov.uk/pricereview/pr09phase1/pap_con_menuregulation.pdf?download=Download#).

of regulatory error without always providing sufficient offsetting benefits from improved economic efficiency. In our view, such features will only be desirable in certain circumstances and should therefore be considered on a case-by-case basis.

We agree with the ACCC that access prices should be structured to prohibit predatory pricing.

2. Setting the initial RAB

The purpose of setting a RAB is to set an expectation for the regulated business as to what level of revenue they can expect to recover in the future. As telecommunications services are capital-intensive, the value of the initial RAB is likely to be the main determinant for the level of access prices into the foreseeable future. Given the network is largely made up of existing (sunk) assets, the value placed on those assets will determine the base on which prices are set. Over time, additional expenditures on maintaining and refurbishing the network will be added to the RAB in one form or another. However, given the long-life of many assets it will take a considerable amount of time for this additional expenditure to influence pricing.

We support the ACCC's adoption of a DAC methodology to determine the initial RAB. We note the ACCC proposes to adopt an initial RAB value of \$7.5 billion for CAN assets and \$5.8 billion for Core assets based on its DAC valuation. While we support the methodology used to determine the asset valuation, VHA does not comment on the appropriateness of specific asset values. We do however note the importance of ensuring that assets comprising the CAN and assets that are part of the CAN (that is, core network assets) must be properly treated. The asset classes adopted by the ACCC are set out in **Table 1**. If the Pricing Principles for fixed line services are to be effective it is imperative that Telstra is only able to recover the costs related to the provision of such services once. The ACCC must not allow Telstra to use such assets to earn additional revenue from the delivery of other declared (or undeclared) services such as the domestic transmission capacity services (**DTCS**) as it would lead to over-recovery of costs.

Table 1: Asset class for the CAN and Core

CAN asset classes	Core asset classes
Ducts and pipes	Switching equipment - Local
Copper cables	Switching equipment - Trunk
Other cables	Switching equipment - Other
Pair gain systems	Inter-exchange cables
Radio CAN	Transmission equipment
Other assets	Radio bearer equipment
	Satellite equipment
	International network cables

Source: ACCC.

We note and support the ACCC's observation that the use of actual, objectively verifiable costs is more transparent than a revenue-based approach to asset valuation. However, we disagree with the ACCC that current indicative prices have been subject to extensive regulatory scrutiny sufficient to mitigate the circularity issues arising from any revenue-based asset valuation methodology. It would be entirely inappropriate for the ACCC to use revenue-based methodologies to value assets when current regulated prices, which are already subject to debate, are to use estimate cash flows for which future regulated prices are to be derived. If, as suggested by the ACCC, it were possible to set aside the circularity issue it would mean the asset value would only be accurate in the event that future regulated prices were exactly equal to anticipated trajectory of current regulated prices. While we note that the proposed indicative prices are very similar to the current indicative prices, such an approach to asset valuation will generally be unsatisfactory without presupposing a regulatory outcome.

3. Determining the revenue requirement

The ACCC's proposed approach to determining the revenue requirement will promote certainty. In particular, de-coupling tax liabilities from the capital cost of earnings (see **Figure 1**) is likely to remove one of the most contentious aspects of the BBM as previously applied in other industries. The BBM approach as proposed by the ACCC has four clear elements:

- > forecast operating expenditure for each year;
- > a return of capital to the regulated firm (that is, depreciation);
- > a return on capital to the regulated firm (that is, providing a return commensurate with firms level of risk for its efficiently incurred investments); and
- > forecast tax liabilities.

Despite mention of a fifth element – efficiency mechanisms and service quality incentives – the ACCC has not, at this stage, provided any detail on mechanisms or incentives beyond the scope of the standard BBM. VHA agrees with the ACCC that service quality incentives are not required given that such incentives may be susceptible to gaming opportunities.

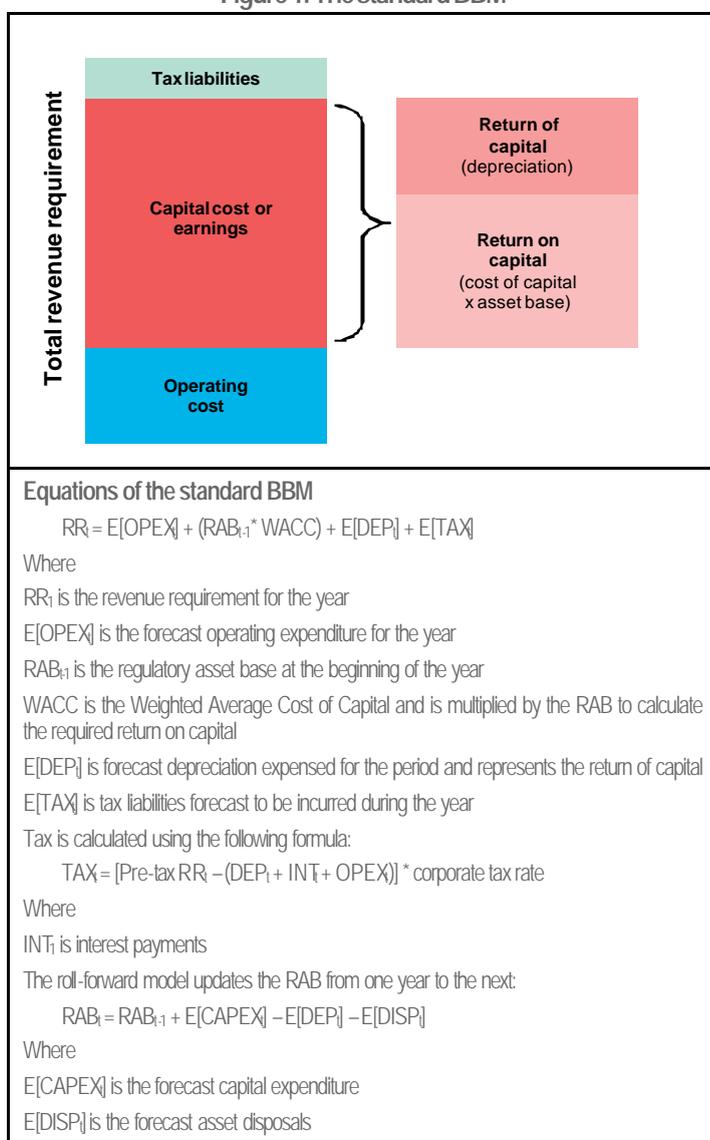
While the four 'blocks' of the BBM are relatively simple to conceptualise, there are several areas of complexity within establishing the revenue requirement associated with each of these components. Arguably, the most challenging elements are the treatment of depreciation, the determination of the appropriate cost of capital and mechanisms to ensure that only prudently-incurred capital expenditure is included.

3.1 Depreciation method

VHA is generally supportive of the ACCC proposed approach to adopt a straightline depreciation schedule under the BBM. Straightline depreciation is the most common, simple and transparent means of determining the return of capital. It also consistent with the approach the ACCC and the Australian Energy Regulator have taken in the past.

VHA notes that there might be some circumstances where it is more appropriate to front-load or back-load the depreciation schedule. The ideal depreciation profile might depend on a range of factors including changing demand for services, risk of bypass, and the opportunity of new services to be supplied by the existing network. As the ACCC notes, depreciation could be front-loaded where there is a high degree of uncertainty over an operator's ability to recover the costs of capital in the future. Back-loaded depreciation may be appropriate where demand is initially uncertain and/or insufficient to recoup depreciation allowances based on straight

Figure 1: The standard BBM



Source: ACCC, VHA

line depreciation. While the ACCC is unlikely to be in a position to know these factors in sufficient detail to set an 'ideal' depreciation profile, it should nevertheless be cognisant of the implications that a simple, straight line depreciation schedule has on economic efficiency.

3.2 Cost of capital

The cost of capital used by the ACCC in its pricing principles should reflect the normal risk-adjusted return on investments undertaken by the access provider. The most common, and arguably most appropriate, method to determine the rate of return for the ACCC's pricing purposes is to use the Weighted Average Cost of Capital (**WACC**). The WACC reflects the return required to support a firm's mix of debt and equity financing. Its calculation is firm specific – it is necessary to calibrate the WACC to ensure the regulated firm's rate of return is commensurate with its level of commercial risk.

The consideration of risk should not be restricted to the firm's regulated activities. The WACC must reflect the firm's opportunity cost of capital. A WACC, solely based on regulated activities, that delivers a lower expected rate of return than the firm can otherwise achieve on its unregulated activities will simply encourage a capital-constrained firm to focus its investments outside its regulated activities. In our view, such an incentive does not provide a sound basis for a sustainable regulatory regime aimed at encouraging efficient investment in infrastructure.

The only mechanism used by the ACCC to distinguish between regulated and non-regulated activities is the choice of firms used to benchmark the equity beta and, to a lesser extent, the debt to equity ratio. While we generally support the ACCC's use of telecommunications firms from selected advanced countries, we note the ACCC could have also included firms focused on content or directory services, or firms that provide mobile-only network services. That said, the use of benchmarks, particularly international benchmarks, does little more than provide an initial reference point to assess the equity beta for a firm the size and complexity of Telstra. The ACCC must focus on the firm-specific risks for the regulated firm rather than the broader consideration of international industry-specific risks. Telstra's equity beta (0.22) lies well below the average equity beta benchmark from the sample (0.68), indicating that Telstra is an outlier indicating that from an investment perspective it exhibits far less risk than its international peers.⁶

We support the ACCC's approach to use a real vanilla WACC. The ACCC's proposed approach to the parameters used to determine the WACC is, for the most part, sensible. We do note, however, that the ACCC would be justified in adopting a more conservative approach to estimating the equity beta based on Telstra's firm-specific risks (as outlined above).

The ACCC's approach to the debt risk premium may overstate the premium required for a firm such as Telstra. The ACCC approach is based on inferring the 10-year Arated bond yield from the 7-year Arated bond yield and the 10-year AAA-rated bond yield. The methodology is driven by the target credit rating and the term to maturity; it may not appropriately account for industry specific factors. We note that the NSW Independent Pricing and Regulatory Tribunal (IPART) stated that: "since the onset of the [global financial] crisis, a company's industry sector appears to be more important its credit rating in determining its debt margin".⁷ This led IPART to believe that that a set of securities selected on the basis of credit rating may be the best benchmark for regulated businesses.

IPART's subsequent investigation of the matter found that while it was possible to include corporate bonds that matched their target credit rating (BBB+ to BBB), it was difficult to find corporate debt issues with a maturity of 10 years for the utilities its regulated. Given the capital

⁶ 5 year monthly equity betas from ACCC (2010), *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft report, September, p71.

⁷ IPART (2009), *Estimating the debt margin for the weighted average cost of capital* Discussion paper, p2.

intensive nature of the fixed line telecommunications industry, it is imperative that the ACCC accurately estimate this parameter. In our view, further research is required on the debt risk premium to support the approach taken by the ACCC.

The ACCC must adopt a robust approach to estimating all of the WACC parameters. For instance, parameters such as gamma or the effective tax rate do not appear to exert much influence over the outcome for the vanilla WACC, such parameters are highly firm-specific and the gamma used for Telstra, for instance, would not be applicable to a firm such as VHA.

3.3 Capital expenditure, operating expenditure and efficiency mechanisms

The forecast capital expenditure and operating expenditure are one of the most critical inputs into the determination of prices using the BBM approach. As noted above, such forecasts are set by the regulator on an ex ante basis (that is, prior to the period in which the regulated firm's revenues and costs are generated). However, the firm's profitability depends on the actual operating and capital expenditure. On the one hand, this approach provides incentives for the regulated firm to pursue cost efficiency as this would improve profitability. On the other hand, such incentives mean that the consumers may, by definition, pay more than is required. Furthermore, the approach the regulated firm with an incentive to shift the timing of its expenditure to later in the regulatory period whenever it has the option to do so.

These incentives for regulatory gaming by the regulated firm are well known. It is essential that the ACCC maintain transparency over the cost inputs. VHA does not comment on the specific forecasts for capital expenditure and operating expenditure used by the ACCC. Although, we note the commentary provided by Frontier Economics on capital and operating expenditure in the attachment to the CCC submission. In particular, forecasts must reflect the underlying cost drivers affecting the industry. For instance, given the technology transition from copper to fibre over the next few years it is unlikely that capital and, to a lesser extent, operating expenditure would be sustained at historic levels.

We support most of the efficiency mechanisms proposed by the ACCC, including:

- > prudence checks on capital expenditure;
- > a carry-forward mechanism to share the benefits of efficiency gains between the access provider and the access seeker; and
- > cost pass-through mechanisms to ensure that regulated firms can pass-through unforeseeable increases (or decreases) in costs to access seekers that arise as the result of external events. We anticipate this mechanism would only be used in very limited circumstances.

However, the ACCC must provide more details on how it intends to apply such efficiency mechanisms. For instance, it is not clear whether such mechanisms will be applied periodically throughout the regulatory period (for example, every year) or whether such mechanisms will be applied at the end of the relevant regulatory period.

We note the ACCC's reference to the use of a competitive tender process for some inputs as a form of efficiency mechanism. While we see some merit in such an approach, the appraisal of tenders by the ACCC would be intrusive, commercially sensitive (limiting its transparency) and, most likely, to fall outside the scope of the ACCC's regulatory expertise. For these reasons, any reliance by the ACCC on the use of a competitive tender process is prone to regulatory error.

4. Setting prices for specific services

The critical factors in setting prices for specific services are the:

- > demand forecasts;
- > cost allocation factors; and
- > the form of price control.

While VHA does not comment on the appropriateness of the demand forecasts, we do consider that the ACCC must provide more evidence the rationale behind its forecasts. Reliable demand forecasts are essential in calculating accurate cost-based unit prices. We note the ACCC proposes that demand forecasts must accord with the following principles:

- > the approach and methodology the access provider adopts must be appropriate;
- > the assumptions made by the access provider must be reasonable;
- > the data used must be current and accurate;
- > the key demand drivers must be taken into account (for example, these could include factors like population growth, technological advancement, household income);
- > the methodology must be correctly applied;
- > the forecasts must be consistent with trends observed in actual historical RAF data, or it must be explained why a divergence from the trend is expected.

The ACCC must develop a robust methodology to forecast demand. In particular, the methodology must be transparent and reconcile with historical trends. While historic data is subject to a number of caveats, forecasts for ULLS and WLR could, for instance, be based on autoregressive statistical techniques. If such techniques prove robust then departures from trend due to, for instance, the deployment of the NBN, could be separately analysed with adjustments made to the trend data.

The relative price of fixed line access and wholesale services is important. For example, fixed broadband services can be delivered over a copper line using either the ULLS or LSS. (We note the LSS can only be provided in association with the provision of an underlying PSTN voice service on the same line). Therefore, the ACCC's approach to setting prices for specific inter-related services requires an additional layer of sophistication to account for relative price effects (that is, cross-price elasticity) particularly when undertaking its sensitivity analysis regarding any demand forecasts.

Economic theory tells us that the most efficient way to recover these fixed and common costs is through so-called Ramsey prices. Ramsey prices are calculated as a mark-up on the incremental costs of a service to recover the fixed costs. The mark-ups to be applied to each service are calculated to be those that minimise the distortion in consumption of all services whilst recovering the fixed costs. The calculation of Ramsey prices requires information regarding the sensitivity of demand to prices (price and cross-price elasticities).

However, because Telstra is vertically integrated into downstream markets, such flexibility over cost allocations cannot be permitted without damage to competition in the downstream market. In such circumstances, it is more appropriate to take to use activity based cost allocations (for example, routing factors) and full-distributed allocations of common costs (for example, equi-proportionate mark-ups). We understand that this approach is consistent with the approach adopted by the ACCC and is based on the cost allocation factors used in the Analysys Cost Model.



VHA does not comment on the appropriateness of the specific cost allocation factors proposed by the ACCC.

VHA supports the ACCC's decision to adopt an individual price methodology for all declared fixed line services. Under an individual price cap approach, there is less flexibility to move away from cost-based pricing for specific services. We note that absent Telstra's vertically integrated structure there may be strong economic argument to support the use of some form of broader price cap mechanisms. However, as long as Telstra remains vertically integrated it is completely inappropriate to permit Telstra any discretion in setting prices.