

TELSTRA CORPORATION LIMITED

**Domestic Transmission Capacity Service Final Access Determination
Inquiry – Primary Prices**

Response to ACCC Discussion Paper

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Executive Summary

Telstra welcomes the opportunity to provide this submission in response to the Australian Competition and Consumer Commission's (**Commission**) Domestic Transmission Capacity Service Final Access Determination Discussion Paper – Primary Prices, July 2014 (**Discussion Paper**). The Discussion Paper seeks stakeholder views on the methodology and approach to setting the primary price terms for the 2015 Domestic Transmission Capacity Service (**DTCS**) final access determination (**FAD**).

Telstra's view is the domestic benchmarking approach continues to be the most efficient and appropriate methodology for setting regulated DTCS prices, and that maintaining this approach is critical to the continued success of the transmission market and the promotion of the long-term interests of end-user (LTIE).

Telstra has invested (and continues to invest) in building and expanding its nationwide high-capacity transmission network. This network supports the services Telstra provides to its wholesale customers, major enterprise and government customers and millions of consumers, keeping the country connected.

Since the 2012 DTCS FAD, the transmission services market has continued to grow, fostered by a highly competitive and dynamic environment, delivering reduced prices, greater choice and innovative solutions to transmission customers. This in turn has supported the extraordinary growth in mobile, broadband, business and video application consumption by Australian consumers and businesses.

The Commission's current approach to setting regulated DTCS prices has played a key role in the success of the domestic transmission market in Australia. In particular the domestic benchmarking approach taken by the Commission to setting regulated prices for a three year period has provided regulatory stability; which has fostered investment and innovation and promoted effective and efficient commercial outcomes. For consumers this has meant the ongoing development of new retail products – both on fixed and mobile networks – with a diverse range of attributes including higher bandwidths, larger data allowances and significantly improved quality of service.

In 2012, the regulation of DTCS pricing resulted in an average price decline for transmission services. Since then, intensive and expanding competition across inter-capital routes, metropolitan ESAs and many capital-to-regional routes has resulted in further reductions to transmission prices beyond the ACCC determined price levels.

The effects of these developments have occurred across much broader areas than the formal competitive routes and ESAs, with lower prices observed on the regulated routes as well. DTCS is unique among regulated telecommunication services in Australia with access providers facing the credible competition from new entrants, and existing customers having the choice to acquire services from a competitor or building their own infrastructure.

The combination of competitive choice and credible build/buy options means that over the course of the current FAD period, the positive effects of competition have extended far beyond the set of routes the Commission previously determined were "effectively competitive" in 2009.

Setting an appropriate regulatory framework continues to be important to support the ongoing growth of transmission services and to encourage the ongoing investment and commercial innovation required to meet the needs of customers at both the wholesale and retail level.

Telstra considers the high level of activity in the transmission market – lower prices across routes driven by increased competition and the introduction of new products and new service features – would not have occurred without the existing regulatory framework. This framework, which is based on real and observable competition in the market for data services, has provided the stability and incentives to encourage greater competitive activity. Conversely, a more intrusive regulatory price setting approach would have impaired these competitive dynamics.

In order to be effectively competitive in the transmission market, providers are incentivised to compete on price, levels of service, service differentiation, value add and capacity to innovate. Again, these observed outcomes over the last several years extend beyond the exempt routes.

Domestic benchmarking is the best approach for setting transmission prices

The Commission has previously adopted a domestic benchmarking approach to set DTCS prices on the basis that:

- When setting prices for DTCS services in a declared area, the observed prices for similar services supplied in a comparable area with effective competition can provide a good indication of the prices that would prevail if there was effective competition in the declared area; and
- The observed relationship between price, distance, bandwidth and other variables for services offered in areas with effective competition, provides a reasonable and commercially relevant basis for setting prices and price structures in declared areas.

Telstra believes the use of the domestic benchmarking approach ensures the price benefit of competition on exempt routes is passed through to declared routes. Using observed pricing on competitive routes, with appropriate adjustments, is also consistent with a key aim of access regulation, which is to make access to essential facilities available under conditions which mimic a competitive market.

Alternative approaches – such as the use of a forward looking cost model or a historic-cost based Building Block Model (**BBM**) – would result in a materially worse outcome for end users. These approaches would likely disincent and “crowd out” competitive activity in the market and are likely to be complex, time-consuming and costly to implement, with no corresponding beneficial outcome. Further, a cost-based approach is typically used where there is no reasonable basis for assessing the competitive price that would apply other than to estimate it through the use of a cost model. This is not the case with DTCS in that it offers the opportunity to use readily observable competitive market outcomes. Finally, DTCS is also unlike other regulated services in that it comprises thousands of diverse transmission services agreements, from multiple providers – this complexity and heterogeneity would require a highly sophisticated cost modelling approach that would be subject to a high risk of regulatory error.

The current econometric model provides a reasonable fit for competitive pricing data

On the basis the Commission proceeds with its preliminary view that a domestic benchmarking approach continues to be appropriate for DTCS, in principle Telstra considers the current form of the econometric model applies an appropriate methodology to inform regulated prices for DTCS for the upcoming FAD period.

In general, Telstra considers the functional form of the regression model captures the underlying engineering and economics of DTCS. Continuation of the current regression model will provide a level of consistency and stability across regulatory periods. Further, the process of updating the competitive price data used for the model will permit changes to market dynamics of DTCS to be captured. To the extent any changes are made to the model specification, then these should be data driven and informed by robust econometric testing methods.

Stakeholder engagement is key to making appropriate adjustments or refinements to the econometric model, including the competitive price dataset to be used for the 2015 DTCS FAD. Telstra supports a high level of stakeholder engagement (between the Commission, industry and relevant independent experts), with appropriate confidentiality safeguards for access to commercially sensitive information.

Telstra considers an up to date sample price data (reflecting the stock of services in the market as at a given date) is the most relevant data set available to the Commission, reflecting the current

state of the market as well as changes since 2012. Telstra does not support any proposal for periodic re-pricing during the FAD period as, among other things, such an approach is inconsistent with incentive-based regulation; has the potential to distort the market; and will significantly increase the complexity of the regulatory process.

Telstra will reserve its position on specific components of the DTCS regression model until the statistical analysis of the updated competitive price dataset is known. Nevertheless, Telstra considers that:

- Unless statistical analysis of the updated competitive price dataset suggests otherwise, the same level of pricing should be maintained for the SDH and Ethernet over SDH technology interfaces;
- Protection is an important and key differentiator for DTCS and therefore needs to be clearly defined to ensure the regression model produces pricing which properly accounts for the higher levels of protection afforded by services which have substantial but incomplete geographic path diversity;
- Continued inclusion of a quality of service (**QoS**) variable will account for differences between providers and enable prices to be set on the basis of the highest quality of service;
- The adopted three route categories for the 2012 DTCS FAD – inter-capital, metropolitan and regional – remain relevant;
- The use of radial distance remains the most appropriate distance measure within the regression model;
- The Commission should only set benchmark price capacities for which it has a reasonable sample of observations;
- It would be inappropriate to incorporate or account for all commercial discounts, particularly whole-of-business discounts;
- Further examination of demand or utilisation should be undertaken in the context of the regression model analysis;
- There should be no differential treatment of transmission pricing on NBN points of interconnection (**POIs**);
- The level of uplift to apply to submarine cables should be reassessed so it appropriately captures the higher cost factors associated with supplying undersea cables and to ensure continued investment in routes to Tasmania; and,
- It remains appropriate to specify price terms in the 2015 DTCS FAD for stand-alone tail-end services (not tail-end services that are bundled with other transmission services), as there are standalone competing alternatives to these fibre-based transmission services.

Telstra anticipates providing further input on components of the regression model as the consultation process continues.

There is no requirement to include Special Linkage Charges

Telstra does not believe that the Commission should address Special Linkage Charges (**SLCs**) in the 2015 DTCS FAD. SLCs are cost-based charges directly proportionate to the cost of extending the Telstra network beyond what is funded as part of a standard installation, in order to accommodate the specific needs of the customer. As the scope of the infrastructure required will differ in each case, these charges cannot be predicted in advance. It would therefore be inappropriate and impractical to set ex ante FAD prices.

Telstra's experience is that SLCs are able to be implemented and, where appropriate, updated effectively through normal commercial processes and channels. The effectiveness of the commercial approach to SLCs suggests there is no justification for the regulation of these charges.

If the Commission is minded to consider SLCs as part of the FAD process, this should be done as part of the inquiry into primary DTCS prices rather than as part of the separate non-price terms and conditions and supplementary prices consultation. This will minimise the risk of regulatory error which arises from not considering primary and supplementary prices within a single process.

Regulated terms and conditions should align with DTCS declaration

The Commission should provide sufficient regulatory certainty by setting DTCS prices that align with the full period of DTCS declaration. Any proposals to shorten the FAD duration will have the potential to distort current commercial negotiations away from longer term agreements and jeopardise innovation in product offerings and pricing constructs.

Therefore, the 2015 DTCS FAD should apply from the expected expiry of the existing FAD until 31 March 2019. This will allow for regulatory stability and certainty and continue to promote further investment; increased competition; service differentiation and innovation to allow long term and downstream benefits.

1. Introduction

This submission sets out Telstra's views and comments in relation to the pricing and price-related issues raised in the Discussion Paper.

Telstra has provided a separate submission to the Commission's Position Paper on "Telecommunications Final Access Determination Inquiries —non-price terms and conditions supplementary prices" (**Position Paper**). Accordingly, this submission does not cover supplementary pricing issues related to DTCS in detail. However, in the interests of completeness and noting that Telstra has called for certain issues referenced in the Position Paper to be dealt with in conjunction with primary pricing issues, this submission does summarise some of the key Telstra views on such issues.

This submission is structured as follows:

- a) Section 2 provides commentary on the appropriate methodology for pricing DTCS.
- b) Section 3 discusses the issues for setting price terms for the 2015 DTCS FAD.
- c) Section 4 discusses non-price terms for DTCS.
- d) Section 5 discusses facilities access.
- e) Section 6 sets out the commencement and expiry dates of the 2015 DTCS FAD.
- f) The Appendix sets out Telstra's responses to the question raised by the Commission in the Discussion Paper.

2. Methodology for pricing DTCS

The Discussion Paper sets out the Commission's preliminary view that a domestic benchmarking approach continues to be an appropriate model for determining regulated prices for the 2015 DTCS FAD. This preliminary view has been made on the basis that the Commission considers that the key factors relating to the 2012 DTCS FAD Inquiry and methodology are still relevant and appropriate. Specifically:

- A domestic benchmarking approach satisfies the criteria that the Commission must have regard to under subsection 152BCA(1) of the Competition and Consumer Act (CCA) and provides an appropriate balance between resourcing and simplicity; and
- Alternative pricing approaches would likely be more complex, require more resources and potentially impose higher regulatory costs without a materially better outcome in seeking to set efficient pricing for DTCS.

Telstra agrees with the Commission that a domestic benchmarking approach continues to be the most efficient and appropriate methodology for pricing DTCS. Further, Telstra considers that the Commission's use of a domestic benchmarking approach has been critical in facilitating competition in the market since the 2012 DTCS FAD and accordingly the promotion of the LTIE.

2.1 Increasingly dynamic and competitive landscape

As noted by the Commission, since the 2012 DTCS FAD there have been significant developments in competition and pricing in the transmission market.¹ Specifically, since the 2012 DTCS FAD:

- Supply competition has increased significantly, as demonstrated by outcomes of the 2014 DTCS Declaration Inquiry, where an additional 112 ESAs were deregulated, accompanied by increases in the level of investment in data transmission.
- Innovation has intensified as seen by the diversity and range of products, features, functionality and technology offerings now available.
- Price competition has resulted in lower prices on average across the transmission market – including in declared areas.

These developments are discussed in more detail below.

2.2 Competitive supply has increased significantly

Competition in the supply of DTCS has been increasing. This is most readily demonstrated by the additional 112 ESAs deregulated by the Commission as part of the 2014 DTCS Declaration Inquiry using its revised (and more stringent) competition methodology.² Further, the Commission's *Infrastructure Record Keeping Rule* (2013) shows 225 ESAs with five or more fibre competitors.

The introduction of NBN based services is further driving competition while fundamentally changing the competitive dynamics of the transmission market. Firstly, the NBN rollout has created incentives for investment in fibre backhaul to the 121 Points of Interconnect (**POIs**), many of which are already served by three or more competing providers. The rollout of the NBN not only creates incentives for carriers to build to the POIs but also to extend services to regions served by the NBN where this was not previously economically viable. At the same time, NBN Co itself is introducing new alternatives to traditional DTCS tail-end services. The range of competitive alternatives to fibre-based transmission services is discussed in more detail below.

¹ Discussion paper, page 12

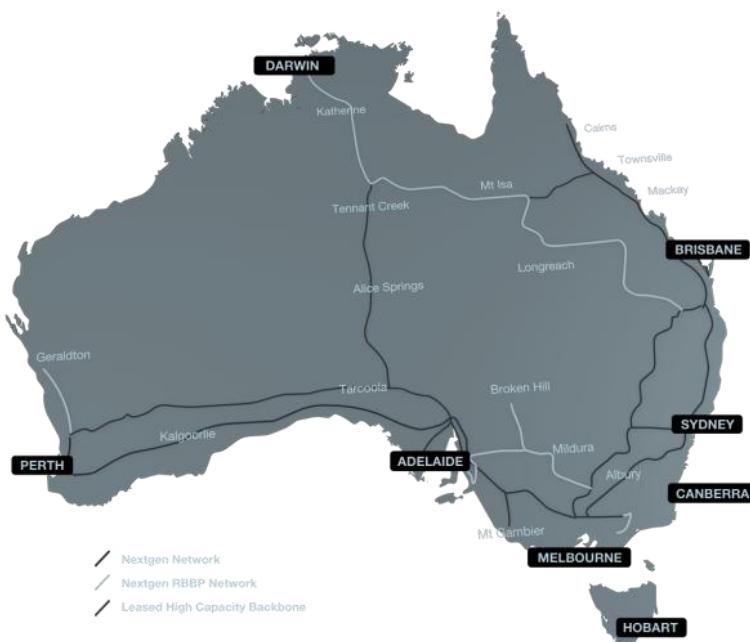
² ACCC (2014) *Domestic Transmission Capacity Service: An ACCC Final report on the review of the declaration for the Domestic Transmission Capacity Service*, March: pp. 10-11.

Another factor driving increased competition is that investment in data transmission by existing players and new entrants has increased significantly. Over the past decade, potential providers and access seekers have demonstrated their willingness to build where the business case has proven compelling. Examples of such investment include:

- In March 2013 Pipe Networks/TPG reported to have more than doubled its length of installed fibre cable since 2009 to over 3,800 kilometres.³
- Vocus has reported 61 per cent growth in fibre network kilometres in FY13 alone.⁴
- In FY14 Amcom reported additional fibre network investment (classified by Data Networks Growth) of \$11.4 million in its 2,200 kilometre national network.⁵
- Nextgen Networks is currently upgrading its 16,000 kilometre network in order to transmit data at 100 gigabits per second.⁶

The strong growth in private investment in fibre transmission is complemented by public investment in regional transmission backhaul. For example, the Commonwealth Government has invested \$250 million in the Regional Backbone Blackspots Program, which is designed to deliver almost 6,000 kilometres of new optic figure backhaul capacity of at least 10 Gbps to approximately 395,000 regional end users. The Regional Backbone Blackspots Program has introduced competition on a number of routes. Figure 1 below shows that the program duplicates Telstra's fibre investments on the Darwin to Adelaide route by connecting Darwin to Tennant Creek via Katherine, then proceeding to Adelaide via Alice Springs and Tarcoola.

Figure 1: Regional Backbone Blackspots Program⁷



³ TPG (2013) *Half Yearly Results Presentation*, <http://www.asx.com.au/asxpdf/20130319/pdf/42drj46s0lvzbf.pdf>, (accessed 1 August 2013)

⁴ Vocus Communications (2014) *FY14 Results Presentation*, 28 August <<http://www.vocus.com.au/wp-content/uploads/2014/08/FY14-FY-Results-Presentation-280814.pdf>> p. 11.

⁵ Amcom (2014) *FY14 Results*, <http://investor.amcom.com.au/IRM/Company>ShowPage.aspx/PDFs/1589-10000000/FY14ResultsPresentation> (accessed 4 September 2014)

⁶ Nextgen Networks "Infrastructure and Network", <http://nextengroup.com.au/about/infrastructure/> (accessed 4 September 2014).

⁷ Source: <http://nextengroup.com.au/services/network/rbbp/>

2.3 Transmission is characterised by high level of product and technology innovation

The Commission notes in the Discussion Paper that, following the 2012 DTCS FAD, Telstra implemented a new product suite for wholesale data services including the declared DTCS service. The components of this product suite most relevant to DTCS are the Managed Leased Line Service (**MLLS**) and the Data Carriage Service (**DCS**).

Telstra introduced the MLLS in response to wholesale customer demand for a service incorporating a product equivalent to the DCS accompanied by a simplified pricing structure and additional enhanced (or value-added) features⁸, such as proactive monitoring. The development and provision of the MLLS by Telstra is indicative of the way the market has responded in offering customers new and innovative products, and highlights how competitive pressures and appropriate regulatory settings have incentivised service providers to develop and offer additional features or functionality that go beyond the scope of the regulated DTCS.

In addition to the introduction of new transmission products, a range of competitive alternatives to fibre-based transmission services have continued to emerge. These alternatives – including digital microwave, copper bonding and satellite services - are providing intense competition for defined segments of the market, most notably for lower speed transmission tail end services. For example, in addition to its 11,000 kilometre fibre network, AAPT has developed a symmetric tail end service product which offers transmission speeds up to 80 Mbps over copper bonding delivered via the unbundled local loop.⁹ At the same time there has been substantial growth in the supply of other types of non-regulated data services, such as asymmetric and contended services, that still provide for competition to the traditional DTCS in many circumstances.

2.4 DTCS market is delivering competitive outcomes across the market

The 2012 DTCS FAD pricing resulted in an average decline for regulated transmission services. In addition, since 2012 there is evidence of ongoing price competition in such routes and ESAs that has resulted in pricing below the regulated rates. That is, significant price competition is observable beyond the routes or ESAs that are formally exempt or not regulated, and has delivered outcomes across a broader footprint that includes regulated routes. This clearly suggests that the presence of competitive infrastructure is promoting price (and service) based competition in a growing number of competitive and contestable routes and ESAs. These outcomes provide compelling evidence that existing regulatory settings are actively enhancing competition rather than simply substituting for competition, which is in the LTIE.

Further, Telstra notes that the Commission has access to a significant amount of DTCS price information across access providers under the contract disclosure regime. This information should also be used by the Commission to confirm the extent to which competition is occurring within the transmission market, including outside exempt routes.

2.5 The regulatory approach has promoted the LTIE

In regulating DTCS transmission services, the Commission seeks to promote the LTIE of telecommunication services by:

- Promoting competition in the market for telecommunication services;
- Ensuring any-to-any connectivity; and
- Encouraging economically efficient use of, any investment in, infrastructure by which the service is supplied or capable of being supplied.

⁸ including features outside the scope of the declared service itself.

⁹ AAPT, "AAPT Mid-Band Ethernet", <https://aapt.com.au/mid-band-ethernet> (accessed 29 July 2013).

The approach taken by the Commission in the 2012 DTCS FAD has facilitated and promoted new services and pricing constructs that have enhanced competition and promote the LTIE. Amongst other things, the outcomes of the 2014 DTCS Declaration Inquiry demonstrate that this is being achieved. Further, as discussed above, Telstra considers that the Commission's competition assessment is a conservative one that understates the true level of competition in the market which extends beyond the footprint of regulated transmission routes.

Telstra's view is that the high level of activity in the transmission market – price competition , increased infrastructure investment, the introduction of new products and new service features – and enhanced innovation would not have occurred absent the influence of the current FAD. The existing DTCS regulatory framework has worked effectively to promote competition by incenting new investment and product innovation and differentiation. It has done this by using observable pricing data from competitive routes in order to predict annual prices for DTCS services in uncompetitive (declared) areas or routes as if they were competitive with appropriate calibration to take into account differences in routes, density and distance and levels of service offered in the market. Prices on competitive routes are broadly reflective of costs (inclusive of a normal return on investment) and provide an appropriate estimate of efficient prices that would prevail in competitive markets.

Further, Telstra considers that it is unlikely that these outcomes would have occurred to the same extent under alternate regulatory approaches (such as bottom up cost modelling or different regression methodologies). Specifically, a regulatory approach that incorporated – for example – more aggressive price setting or mid-period resets would not have resulted in the same competitive outcomes. In particular, the absence of regulatory certainty that would result from periodic regulatory price reviews would dilute incentives for introducing new products, alternative pricing structures and value-add functionality, and aggressive price setting approaches would limit the scope for ongoing price competition. .

2.6 Pricing approach to DTCS services

As noted above, Telstra considers that the domestic benchmarking approach continues to be the most efficient and appropriate methodology for setting regulated DTCS prices. Further, alternative approaches – such as a forward-looking fully allocated cost (**FAC**) model or an historic cost-based Building Block Model (**BBM**) (e.g. the Commission's Fixed Line Services Model (**FLSM**)) – are likely to be more complex, time-consuming, costly to implement and prone to outcomes involving regulatory error than domestic benchmarking, with no corresponding beneficial outcome. Accordingly, adopting one of those alternative approaches would not be in the LTIE.

2.7 Domestic benchmarking is the more efficient and appropriate approach for setting transmission prices

Prior to the introduction of regulated pricing for DTCS, the Commission consulted extensively on the range of approaches that could be taken to pricing DTCS.

The approaches considered included bottom-up long-run incremental cost, top-down long-run incremental cost, fully allocated cost, international and/or domestic benchmarking and a combination of such methodologies. The Commission ultimately concluded that domestic benchmarking was the most efficient and appropriate approach for setting transmission prices on the basis that:

- When setting prices for DTCS services in a declared area, the observed prices for similar services supplied in a comparable area in which there is effective competition can provide a reasonable indication of the prices that would prevail if there was effective competition in that declared area; and
- The observed relationship between price, distance, bandwidth and other service variables for services offered in areas with effective competition, provides a reasonable (and commercially relevant) basis for setting prices and price structures in declared areas.

In the Discussion Paper, the Commission considers that the key factors relating to the 2012 FAD Inquiry and methodology are still relevant and appropriate. Accordingly, the Commission's preliminary view is that a domestic benchmarking approach continues to be the appropriate model for determining regulated prices for the 2015 DTCS FAD. Telstra agrees with the Commission's preliminary view.

As outlined in Section 2.5, Telstra considers that the Commission's use of a domestic benchmarking approach has been critical to the success of the market and promoting the LTIE. In particular, the use of the domestic benchmarking approach ensures that the price benefits of competition on exempt routes are passed through to those routes assessed to be non-competitive. Further, Telstra considers that the domestic benchmarking approach taken by the Commission has resulted in the footprint of competition extending beyond the exempt routes. That is, price competition has resulted in prices lower than the regulated price including for a significant number of non-exempt routes.

The primary aim of access regulation is to make access to essential facilities available under conditions which mimic a competitive market. Generally, it is not possible to observe the competitive supply of access to essential facilities or services, and so proxies for competitive outcomes – such as the estimation of bottom-up "cost-based" prices are used, which are determined through cost models. DTCS is unique in terms of declared telecommunications services in that it does offer the opportunity to observe similar services supplied on a competitive basis in comparable areas, and use competitive market outcomes as a basis for setting regulated prices in declared areas. As the Commission has recognized in exempting transmission routes from DTCS declaration, the exempt routes are effectively competitive. Indeed, as described in Section 2.2, the transmission market as a whole is characterised by the presence of multiple providers who are continually investing to expand their network reach and provide a greater range of services to access seekers. Consequently, and in contrast to other declared services, the Commission is able to readily observe competitive pricing for the service in a comparable environment.

The use of competitive prices in comparable areas as a benchmark to set service pricing in declared areas is clearly a superior approach to seeking to estimate a cost-based price (through a particular cost-modelling approach) as a proxy for competitive prices in such areas. The domestic benchmarking approach also ensures that the pricing of regulated transmission services captures demand-side developments, which will not be the case with cost-based approaches. This is because the pricing captured through domestic benchmarking is the outcome of negotiated commercial deals.

An additional feature of domestic benchmarking is that it will respond to and reflect improvements in competition and innovation occurring on competitive routes. In this way the approach allows access seekers in declared areas to benefit from price and service competition in competitive areas. The Commission has previously recognised that "any reduction in market prices would be expected to flow through to subsequent regulatory prices."¹⁰ Downward pressure on pricing (to the extent it is a feature of competitive markets) is a feature of the domestic benchmarking approach and will be reflected in the regulatory pricing outcome. Most, if not all of the downward movement in DTCS prices over time will be associated with variables already controlled for within the current 2012 DTCS FAD regression model and will be reflected through re-estimation process and adjustments to the co-efficients based on new competitive price data.

Finally, the complexity of DTCS product set means that any approach to setting prices must be able to reflect a wide range of service types, geographies and other characteristics. DTCS service description encompasses a broad range of transmission services requiring a number of service types to be priced at an array of bandwidths, distances, product and firm specific attributes. Accurately pricing DTCS is therefore a difficult task as it is important to effectively

¹⁰ ACCC Final Access Determination for the Domestic Transmission Capacity Service Explanatory Statement June 2012 p. 31

account for the complex inter-relationships between the factors that affect DTCS pricing. The domestic benchmark approach can effectively capture these factors and provide for appropriate price points for the range of services.

Telstra also agrees with the Commission that alternative approaches are “*...likely to be more complex, require more resources and potentially impose higher regulatory costs.*” In general benchmarking is more straightforward and implementable than a cost-based approach. This reduces the risk of material regulatory error which could impair investment and innovation in the transmission market. The domestic benchmarking approach for DTCS has been well-established by the Commission and the experience of industry since the 2012 DTCS FAD will facilitate effective refinement of the regression model used by the Commission. Leaving aside the fact that domestic benchmarking is the most efficient and appropriate approach, Telstra considers that time and resources available for the 2015 DTCS FAD Inquiry would be most effectively directed to model refinement rather than establishing a new pricing methodology which will not provide a materially better outcome.

2.8 Cost-based pricing is increasingly complex and associated with significant risks and regulatory error

The Discussion Paper notes that in the 2012 DTCS FAD Inquiry, some stakeholders argued that a cost-based approach such as a FAC model or BBM may be more appropriate to set regulated prices. Telstra does not agree with these arguments.

Generally speaking, regulators utilise cost-based models to determine prices that provide a proxy for those that are likely to be offered in a competitive market. As noted in section 2.7, regulators are rarely (if ever) in a position to be able to observe competitive price outcomes for similar services supplied in comparable areas, therefore regulators must rely on proxies for competitive outcomes to set access prices. This is clearly not the case with the transmission market in Australia. Given that directly observable competitive prices are available from multiple service providers, cost-based pricing is clearly a second-best approach for DTCS.

A further limitation in the use of a cost-based approach to setting DTCS prices is that the complexity and heterogeneity of the service would make the task of modelling costs and establishing cost-reflective prices highly complex, time consuming and highly likely to result in regulatory error. As noted by the Commission, DTCS is unlike other regulated services in that it comprises thousands of diverse transmission service agreements. These individual transmission services vary according to factors such as capacity, distance and quality of service. Further, variation of commercial prices and levels of demand across various route categories add to this complexity. Telstra considers that the unique characteristics of transmission networks and the regulatory structure of DTCS (with a mix of regulated and non-regulated routes) would create difficulties in allocating costs as would be required for a cost-based approach.

If it were to be attempted, the complexity and heterogeneity of DTCS would require a highly sophisticated cost modelling approach, which is likely to be an expensive and time-consuming exercise. Cost-based pricing would require the collection of a significant amount of detailed cost information from all transmission suppliers in order to generate a diverse range of prices for the regulated transmission routes. The information requirements to adequately establish reasonable price terms using this approach are beyond the current Regulatory Accounting Framework (both in terms of the data captured and the entities to which that regulatory requirement applies). Telstra also considers that it would be inappropriate to base regulated prices for DTCS solely on Telstra costs as this would, amongst other things, penalise suppliers who do not benefit from the same economies of scale or cost efficiencies.

Further even where data collection is achieved, a comprehensive cost allocation framework would be required in order to set prices for multiple geographic areas, over multiple bandwidths and multiple distances across multiple providers. This is a complex exercise that would introduce a high risk of regulatory error, particularly where the cost base is difficult to define.

The Commission noted the risks associated with a cost-based approach in its 2012 DTCS FAD Inquiry:

"The ACCC's review also observed that most prices are generally linked to the costs associated with providing a given quantity of a service where there is competition. Where the cost-base is difficult to define and/or determine the risk of regulatory error is high."

"The ACCC decided that a domestic benchmarking model was its preferred pricing model for the current market. This was because there are number of routes or areas within Australia that are regarded as being provided in competitive markets and these prices can be used as a benchmark for the prices that would prevail in the non-competitive or regulated routes and areas, if they were competitive."¹¹

Given the broad scope of DTCS, the range of different operators supplying transmission, and the differences in cost structures between routes, it is unlikely that a cost-based approach would deliver materially better pricing outcomes, which would promote the LTIE.

None of the cost-based pricing approaches are appropriate, but for completeness it is worth noting that some of these approaches would result in an even greater risk of regulatory error and detriment to the LTIE than others.

In broad terms, cost-based approaches are either forward-looking or historic-cost based. An example of a forward looking cost-based approach is the Total Service Long Run Incremental Cost (plus) (**TSLRIC+**) approach. In theory a TSLRIC+ methodology, characterised by an appropriately estimated efficient operator would incentivise transmission providers to achieve economic efficiency as well as invest and innovate. If appropriately implemented, TSLRIC+ can also ensure that an efficient operator earns an appropriate return and recovers all relevant costs.

While Telstra does not consider that a cost-based approach would be appropriate for DTCS (both due to the clear superiority of domestic benchmarking, as well as the inherent complexities of estimating cost-based prices), if the Commission was minded to adopt such an approach it should be based on a forward-looking, TSLRIC+ methodology.

Telstra notes that a number of stakeholders have suggested that the FLSM could be appropriated for the purposes of DTCS pricing. The Commission considers this in the Discussion Paper:

"The FLSM can provide an estimate of the revenue requirement relating to the transmission assets in the FLSM but it does not include all the relevant costs and cannot be used to identify or take account of other factors relevant to particular routes (for example, demand, route type and the level of protection available)."

Indeed, the FLSM is not a ready-made model suitable for DTCS pricing purposes.

The FLSM is a historic cost-based BBM model and a Telstra-only model built for a particular purpose. Specifically, the FLSM is designed to facilitate the application of a BBM to set prices only for declared fixed-line services – services which are provided by Telstra over its fixed-line telecommunications network. In broad terms, the use of the FLSM to either set DTCS prices, or to be used as a "check" on DTCS price outcomes, is entirely inappropriate for two reasons. First, the historic cost basis of the model would be inappropriate for application in a market where participants clearly face a build/buy choice and there is ongoing investment and competitive bypass existing infrastructure. Second, the FLSM does not contain sufficient information to the detail required to provide meaningful estimates of DTCS costs or prices.

¹¹ ACCC (2014) *Domestic Transmission Capacity Service: Final Access Determination Discussion Paper – Primary Prices*, July: p. 11.

The asset values within the FLSM are based on the written down historic costs of a sub-set of Telstra's assets as at June 2009. Subsequent changes to the RAB reflect the assumptions made in the context of setting fixed-line services prices in determining capital expenditure forecasts and depreciation profiles. The use of historic cost-based models can be reasonable in the context where there is limited threat of bypass by access seekers due to the presence of clear natural monopoly characteristics in the relevant assets and services. In the case of the FLSM, the major assets – comprising the copper-based Customer Access Network and associated duct network – do exhibit natural monopoly characteristics, in part due to the fact that these assets are in the process of being replaced by the NBN. Given these particular circumstances, the use of a BBM with a Regulatory Asset Base (**RAB**) reflecting historic costs is a reasonable regulatory approach.

However, as outlined earlier in this submission, and reflected in the Commission's Final Decision in DTCS re-declaration inquiry, competition and competitive investment is ongoing with respect to DTCS service and relevant infrastructure. In such a context, the use of written-down historic asset values would only serve to undermine potential competitive entry and dilute competitive dynamics in the market.

The second major limitation of the FLSM for use in setting DTCS prices is that simply does not contain sufficient information on the relevant costs, assets or use of assets to provide meaningful information in this context. The purpose of the FLSM is clearly to set prices for the defined set of regulated fixed-line services, and the model structure, assumptions and inputs reflect this specific purpose. The FLSM has significant limitations in terms of providing sufficient information on all transmission asset categories, the provision of appropriate cost allocators and/or to determine the actual revenue requirement for all transmission services, let alone derive specific prices for regulated routes.

2.9 Stakeholder engagement is key to refinement of the regression model

On the basis that the Commission proceeds in line with its preliminary view that a domestic benchmarking approach continues to be appropriate for DTCS, in principle Telstra considers that the current form of the econometric model applies the appropriate methodology to inform regulated prices for the 2015 DTCS FAD.

Telstra's position on components of the regression model for DTCS services is provided in Section 3 of this submission. In general, Telstra considers that the functional form of the regression model captures the underlying engineering and economics of DTCS. Continuation of the current regression model will provide a level of consistency and stability across regulatory periods. Further, the process of updating the competitive price data used for the model will permit for the dynamics and market developments of DTCS to be captured. As a result, Telstra is advocating no significant changes to the regression model to calculate benchmark prices for the 2015 DTCS FAD.

However, like the Commission, Telstra is mindful that a number of stakeholders have raised issues relating to the refinement of the regression model – during the 2012 DTCS FAD and since its implementation. Further, the specification of the dataset to be used for the 2015 DTCS FAD will be critical to estimating DTCS pricing that appropriately reflects the competitive nature of DTCS and is therefore in the LTIE.

The Discussion Paper sets out the Commission's proposal for the engagement of stakeholders for the consideration of regression model refinements, as well as the 2014 dataset to be used. Specifically, the Commission considers that a collaborative approach (between the Commission, industry and relevant independent experts) will assist in determining the appropriate regression modelling analysis to inform prices for the 2015 DTCS FAD. Telstra agrees with this approach.

In terms of the specific confidentiality safeguards required to ensure that relevant experts have appropriate access to confidential raw price data to assist the Commission, Telstra considers that:

- Raw price and service data should not be provided to any commercial parties;

- Raw price and service data should only be provided to recognised independent experts that commercial parties engage for review of the regression model; and
- Raw price and service data should only be provided to recognised independent experts where necessary confidentiality undertakings are in place.

The competitive nature of the transmission market in Australia requires that the Commission ensure that raw price and service data is not made available to any parties that may engage or be related to strategic or financial decisions associated with the supply of DTCS.

3. Issues for consideration of price terms of the 2015 DTCS FAD

Telstra considers that the underlying functional form of the 2012 DTCS FAD price regression model forms a reasonable starting point for estimating prices for the forthcoming regulatory period.

The 2012 DTCS FAD regression model specification,

- generally accords with the underlying engineering and commercial contexts of DTCS (such as distance, bandwidth, product type, quality of service characteristics and levels of protection), and
- effectively captures the main economic drivers (efficient cost, scale and demand-side aspects) of the service.

In addition, the current econometric framework in the regulatory process provides for simplicity and transparency of the benchmark methodology in the FAD. The outputs of price regression model analysis are visible and translate to tractable price setting rules for the complex and heterogeneous DTCS product set.

The following sections set out Telstra's view on the price setting terms for DTCS and the individual components of the regression model.

3.1 Price setting for DTCS

3.1.1 New competitive price data should inform the regression model specification

The accuracy of any econometric approach relies on the key price drivers of DTCS being effectively captured; with necessary adjustments being made to account for the heterogeneity associated with supplying DTCS.

The current model achieves the required balance in this regard. The model specification covers major considerations such as distance, product type and technology, capacity/bandwidth, route category, protection and firm specific heterogeneity, which accounts for higher quality of service characteristics. Additionally, changes in demand or supply of DTCS will be reflected through adjustments to the key determinants of prices and flow through to the predicted FAD prices for regulated DTCS routes.

Accordingly, Telstra supports the current form of the econometric model. Employing new competitive data will further inform whether consideration needs to be given to changing any aspects to the underlying functional form of the model. However, any such changes would require careful consideration and should be data driven and informed by robust econometric testing methods. In particular, Telstra advocates that any changes to the regression model would need to be supported by detailed analysis on the criteria of fit, statistical significance and use of model selection criterion (such as the Akaike Information Criterion or Bayesian Information Criterion).

Through the 2012 DTCS FAD Inquiry, detailed consultation and exploratory data and statistical analysis conducted by Data Analysis Australia (**DAA**) assisted the Commission on the determination of the final regression model specification. Telstra supports a continuation of this level of engagement with multiple stakeholder inputs allowing for the assessment and the determination of the regression model specification and sample selection procedures. This process has ensured a significant level of transparency and industry input in determining the most appropriate price setting terms for DTCS.

3.1.2 Sample selection should be based on the current stock of competitive DTCS services

The sample competitive price data used for estimating price terms for the 2015 DTCS FAD should reflect the stock of DTCS services currently supplied in competitive areas by all relevant service providers. Sample selection should not be artificially constrained either by supplier or the date at which a current, live service was first supplied.

These competitive price data would not only provide a view of current state of DTCS market but also reflect the changes that have occurred since the 2012 DTCS FAD; capturing price movements due to supply and demand fluctuations since the last FAD. Therefore the 2015 DTCS FAD will reflect the changes in competitive DTCS prices compared to historical competitive DTCS prices.

The Commission have also asked whether prices negotiated in 2014 should be used in establishing pricing benchmarks. Telstra believes this would not be appropriate. Establishing pricing benchmarks for the forthcoming FAD period based solely on prices negotiated in 2014 would mean the benchmarks were based on an insufficiently representative sample of all DTCS services in the market. Indeed, even prices negotiated since the January 2014 would only represent a small proportion of services in DTCS market, consisting of re-negotiated services that were already under contract and/or newly contracted services.

Telstra considers there are significant risks with this approach. The non-representative sample and reduced sample size will affect the quality of the benchmark price estimates. In general, more observations within the sample set is always preferred.

Furthermore, a flow on effect is that setting benchmarks only on recently negotiated prices will skew and distort the current commercial context of DTCS, through shifting the incentives to lock-in longer-term contracts.

3.1.3 Longitudinal data is only insightful into price trends of DTCS

The analysis of pricing data from 2011 to 2014 will provide further insight in the changes DTCS prices over previous regulatory period, as well as the demand and supply of DTCS. However, Telstra does not consider that this approach provides any additional benefits but is likely to raise regulatory risks, incentives for commercial negotiation and distort current and future competition.

Under the current benchmarking approach (whereby, the regression model is based on the current stock of DTCS) provides a cross-sectional view. As such, the estimation reflects a point in time and provides explanatory power on key cost-price drivers of DTCS. Changing to an estimation approach based on longitudinal data does not provide any account of future market demand or competition. Whilst it provides an estimate of the changes between competitive price data collection time points, it has no predictive power for future outcomes in DTCS market. Consequently, Telstra sees no beneficial value in the application this approach in the context of the forthcoming regulatory period.

3.1.4 Re-pricing mechanisms pose significant risk to incentives and regulatory stability

Telstra considers that periodic re-pricing during the FAD has significant risks and gives rise to unnecessary regulatory intervention. A review of regulated prices during the term of the FAD either with new pricing data or uniform price adjustments to account for any price movements is inappropriate as it:

- Does not comply with incentive-based regulation;
- Has the potential to distort the market by moving commercial negotiations away from using longer-term agreements; and,
- It results in an asymmetric approach to regulation based on current exemptions and pricing.

A stable price set over the duration of the regulatory period will have more appropriate incentive properties. Ongoing price updates during the course of a regulatory period will deter incentives for an existing supplier or potential entrant to invest or innovate. In effectively competitive markets, a network infrastructure owner that successfully adopts a lower cost technology is rewarded by being able to supply the same service at a lower cost, whilst receiving transitory profits until other suppliers adopt the same innovation. Incentive regulation was designed to mimic or replicate such behaviours. Constantly updating prices removes the potential returns for new entrants and existing suppliers from supplying services that adopt alternative costs technologies. Frequent updating mechanism is more aligned with a cost-plus form of regulation (as opposed to the CPI-X

regulatory approach), which regulators in general have looked to move away from because it distorts incentives for investment and to be cost efficient.

A mid-term updating mechanism will also significantly increase the complexity of the regulatory process, with limited benefits and additional risks and burden to industry participants. Therefore, Telstra considers that it would constitute an unwarranted regulatory interference with market processes.

Telstra notes the Commission considered this issue within the context of the 2012 DTCS FAD and determined that it would not update the FAD prices before the 2012 FAD expired.¹² Telstra believes the same approach should be taken in the context of the 2015 DTCS FAD.

3.1.5 The application of the mean value as regulated price point

In the 2012 DTCS FAD, the Commission opted to select price points at mean value of the range of predicted prices. Whilst this may be intended to balance the risk of setting prices too high or too low, it may lead to systematic over or under pricing. For this reason, the Commission should re-examine the range of price points from the regression model analysis to ensure the balance of risks is appropriate. Telstra remains of the view that the appropriate level of price points cannot be determined for the 2015 DTCS FAD until the statistical evidence from the regression model are presented.

3.2 Components of DTCS regression model

As set out earlier in this submission, Telstra is generally of the view that the 2012 DTCS FAD regression model represented a reasonably good estimation tool for efficient DTCS pricing, appropriately accounted for relevant drivers of cost/price, and provided useful information for the Commission in setting discrete regulated prices terms for services in declared areas.

To the extent the Commission looks to improve the estimation reliability or sophistication of the regression model in the current FAD process, Telstra considers that any changes should be “data led”, whilst also considering the ultimate purpose and practicability of the model in setting regulated prices. The following section outlines Telstra’s initial views with respect to specific components of DTCS regression model. However, Telstra reserves its position here until the detailed analysis of the updated competitive price dataset is known.

3.2.1 Technology interface

DTCS service description as set out in the 2014 DTCS Declaration is technology neutral. SDH and Ethernet over SDH are the two most common technology interfaces currently used in telecommunications networks for the purposes of supplying transmission services, and the service description for DTCS covers both technologies.

Under the 2012 DTCS FAD, the Commission decided not to set separate prices for different technology interfaces. This was based on the evidence that a separate network interface variable was statistically insignificant in determining DTCS prices and therefore did not warrant inclusion in the final regression model. The econometric analysis by the Commission’s consultant DAA during the 2012 DTCS FAD Inquiry found that there was no statistically significant relationship between network interfaces to justify separate prices based on this DTCS feature.

Telstra maintains that unless there are new commercial cost variations between the technologies or other sufficient statistical evidence to suggest that the same level of pricing for both SDH and Ethernet over SDH services is unwarranted, the current form of the regression model should remain in the 2015 DTCS FAD.

¹² ACCC Final Access Determination for the Domestic Transmission Capacity Service Explanatory Statement June 2012 p. 31

3.2.2 Protection

Whilst DTCS service description does not distinguish between protected and unprotected services, the Commission remains of the view that a geographically protected service would be the minimum a DTCS access seeker would require to provide high quality downstream services and that FAD pricing of DTCS should account for protected transmission services. Telstra advocated for protection as an explanatory variable within the 2012 DTCS FAD regression model, as it is an important and key differentiator for DTCS in the market.

Telstra supports the Commission in seeking additional information from data providers on the type of protection for each service to ensure that protection is correctly specified. The 2012 DTCS FAD defines 'protection' as: geographic path diversity in the inter-exchange component of a transmissions service only; it does not extend to the tail-end component of transmission services. Whilst Telstra considers that this definition of protection is a minimum basis and appropriate for use for the 2015 DTCS FAD, it seeks clarification from the Commission as to whether this definition ensures that geographically diverse path protection supplied using other means, such as two single fibre paths, is not captured. Pricing such services on the basis of SDH-based ring network architecture would unambiguously result in below cost pricing.

Telstra also notes that the definition of protection within the 2012 DTCS FAD excludes services which have substantial but incomplete geographic path diversity, and these are thus priced in the same way as a service with no geographic path diversity. Telstra recommends the Commission review this issue and ensure that the levels of protection of higher quality service are captured and accounted for in the pricing method.

3.2.3 Quality of Service

Telstra continues to support the inclusion of a quality of service (**QoS**) variable to account for the differences in quality of service between providers and setting prices on the basis of the highest quality of service.

The 2012 DTCS FAD regression model accounts for the differences in quality of service between different providers by incorporating an assessment of 'quality of service' as a separate explanatory variable. Telstra remains of the view that is most appropriate to adjust for firm specific heterogeneity, thereby setting prices on the highest quality of service provider. To account for any difficulties in modelling the QoS variable, the Commission should make adjustments to ensure against the risk of systematically under-pricing the highest quality of service. The application of the 75th percentile in the pricing would go some way to countering this risk of under-pricing which is contrary to the LTIE.

3.2.4 Route Category

In principle, Telstra considers that the adopted three route categories for the 2012 DTCS FAD regression model inter-capital, metropolitan and regional remains relevant for the upcoming 2015 DTCS FAD. Differences in route type matrices (radial distance or zone based approaches) as used by access providers for the variety of DTCS pricing will be accounted for through estimation of the regression model.

3.2.5 Distance

Telstra considers that the use of radial distance remains the most appropriate distance measure within the regression model. While it may underestimate the real length of a route - not true measure of length of infrastructure supplied. Telstra prices services on the measurement of distance from A-end and B-end exchanges. Radial distance fails to capture instances where wholesale customer POP or end-user is external to exchange and tail-end infrastructure is supplied. However radial distance is a standard industry measure used to price services commercially so it remains reasonable and appropriate for 2015 DTCS FAD.

As with the 2012 DTCS FAD, Telstra notes that it is important that Commission adopts a consistent approach in use of competitive pricing data. In particular, if any prices set by access provider use a different measure then need to be converted for benchmarking. The capture of A-

end and B-end exchanges within the data request will necessitate that data supplied from alternate DTCS service providers.

3.2.6 Capacity

The Commission should only set benchmark price capacities for which it has a reasonable sample of observations within the dataset. Telstra considers where there are fewer observations for higher bandwidth services, and limited variability at this level, it is more difficult to reliably predict outcomes using a regression methodology.

The current DTCS declaration specifies a minimum capacity of 2Mbps. There was general agreement among stakeholders during the 2012 DTCS FAD Inquiry that the Commission should only set prices for the capacities that are commonly available for transmission services. The Commission notes from recent information provided to the Commission and data obtained from DTCS access agreements lodged with the Commission that 2Mbps services are reducing as a proportion of total contracts entered into for DTCS services. The current service description specifies that the network interface for DTCS services is used to provide a transmission rate of 2.048Mbps or above.

Whilst, the Commission expects that there will be an increased level of data for higher capacity services obtained for the 2015 DTCS FAD, Telstra suggest that a reassessment is required on the number of services at higher capacity before the threshold of 622Mbps is removed. The lack of data at bandwidths exceeding 622Mbps in the 2012 DTCS FAD avoided the risk of pricing higher bandwidth services below the cost of supply. Pricing services only up to 622Mbps also ensured that the newer technologies used to deliver the higher bandwidth services have been able to develop.

3.2.7 Contract length and terms

Telstra considers that price setting terms based on a contract period of 12 months remains appropriate for the 2015 DTCS FAD.

In the context of the 2012 DTCS FAD process, Telstra supplied billing data which did not distinguish between short-term agreements (one year) and longer term agreements (three years). To the extent that customers are subject to longer term agreements, these may still be current. Pricing from longer term agreements in the billing data, despite being historic, may therefore actually be reflective of competitive price, and will have some term discount embedded in them.

If there is a sufficient volume of longer term agreements with associated term discounts present in the competitive price dataset, then the predicted prices from the regression model will, on average, result in lower benchmarked prices for regulated services than might otherwise be commercially negotiated by parties for one year contracts for supply. Therefore, the 12 months remains a reasonable basis for price setting for 2015 DTCS FAD in that it is unlikely to result in overpricing.

3.2.8 Discounts

Telstra notes that in the context of supplying competitive pricing data as part of the 2012 DTCS FAD, all service specific and service term related prices¹³ were captured in the billing price data Telstra provided because this price data reflects actual billed charges, rather than charges from list prices, for example. Telstra considers that information of this nature would be sufficient for the Commission to again assess the relevant cost/price drivers of DTCS for the purposes of the 2015 DTCS FAD. This should also allow commercial flexibility for parties to negotiate pricing solutions including a variety of discounts or rebates.

In addition, Telstra considers it would be inappropriate to specifically incorporate or account for whole of business discounts. Whole of business discounts may apply if the access seeker achieves certain agreed volume targets or expenditure thresholds agreed across all the wholesale services that are supplied. The discount is applied to the overall spend by the access seeker, and

¹³ Which can involve discounts from rack rates.

appears at the end of the total bill. Therefore, whole of business discounts cannot easily be allocated to any individual service (i.e. the discount relates to the overall level of wholesale services acquired by the access seeker).

The purpose of the benchmarking approach is to set a benchmark based on data collected of *all* prices available to the Commission, and not just the lowest price or specifically discounted prices. As recognised by the Commission in its 2012 DTCS FAD determination, it is not practical to set regulated prices for every possible discount or rebate that *could* be offered in the market. The pricing methodology should not seek to pick the lowest price in the market at any particular point of time but is intended to predict prices based on the known relationships between price and key variables using a complex regression model and based on an established and consistent dataset. The existing FAD sets the minimum terms and conditions (including price) appropriate for access to the declared service. This approach successfully enabled prices for a standalone DTCS product supplied to be established for a one year period in order to provide a reference point for commercial negotiations.

Having established this reference point, the commercial negotiation process has been efficient and successful in enabling parties to agree prices, including discounts that may apply, for DTCS products, including when sold in a bundle of services or for periods other than one year. Commercial arrangements of this type can vary significantly between parties (including when comparing different providers) and the discounts reflect the reduced risks associated with those parties circumstance. Telstra notes that if the Commission attempted to factor in whole of business discounts in a more prescriptive FAD approach, it would:

- risk distorting commercial negotiations over a whole suite of services (including non-regulated products), as parties would need to make the appropriate adjustments to account for a discount that has already been applied; and
- provide customers who do not achieve any significant scale in use of the service, the benefits of customers who are achieving that scale in the acquisition of services.

By contrast the existing framework has operated successfully by promoting different types of commercial outcomes which are more efficient and mutually beneficial to parties than an regulatory approach that would be unable to take into account specific circumstances of each part and each transaction. Importantly, this approach maintains incentives to incorporate non-regulated services in commercial whole of business arrangements which are, in any event, not within the scope of the DTCS service description. Further, generally DTCS FAD should only set prices for the declared DTCS to which the FAD relates. It would be beyond the Commission's powers to set prices in relation to non-declared DTCS services, or other wholesale services which are not exclusively DTCS.

3.2.9 Demand

The Commission is considering if the effect of demand on non-competitive routes would impact on the benchmarking approach. Demand variables such as population density, business and residential components and expected growth influence the level of transmission services required.

In the 2012 DTCS FAD, Telstra maintained that, while the impact of utilisation relative to the other cost/price drivers may appear to be statistically insignificant, it is nevertheless an important engineering and economic driver of price and cost, particularly on declared regional long distance routes. Telstra considered that one potential explanation for the lack of significance of the utilisation or the demand term was the poor proxies being used.

Again, Telstra proposes that further examination of demand or utilisation using various proxies should be undertaken in the context of the regression model analysis.

3.2.10 NBN POIs

The transition to the National Broadband Network (**NBN**) has and will continue to present a number of challenges to infrastructure suppliers. DTCS services are, and will increasingly be an essential input for the delivery NBN retail based services. As such, Telstra considers that the rollout of the NBN and its 121 Point of Interconnects (**POI**) (almost 80 per cent of which demonstrate a high level of competition and already consist of at least two or more fibre providers¹⁴⁾ will act as sufficient incentive to invest in to the POI.

As noted by the Commission, NBN POIs are likely to form an important location from which transmission investment and competition is likely to emerge. Present DTCS service providers will continue to investment in their networks to these POIs and will likely have the ability and incentives to extend services beyond their current network location to the regions served by a NBN POI. Telstra regards this will particularly be the case for NBN POIs that are located in regional centres (or regulated ESAs), there is greater commercial incentive for to locate transmission fibre to the POI and, consequently, it is likely to create contestability for supply of the service.

Under the current 2014 DTCS declaration, 46 POIs will be subject to regulated pricing in the 2015 DTCS FAD. Telstra considers that the pricing set by the 2015 DTCS FAD will effectively balance the need for investment and further encourage competition at these POIs during the transition to the NBN. Therefore, Telstra considers that DTCS serving POI does not warrant differential treatment within the regression model.

3.2.11 Submarine Cable

For the 2012 DTCS FAD, services between the mainland and Tasmania incorporated a submarine cable route of approximately 300km in length. Based on the data analysis an average price of submarine routes was found to be 40 per cent higher than mainland inter-capital routes. On that basis, the 2012 DTCS FAD included an uplift factor of 40 per cent (on the undersea cable component only) for transmission services to Tasmania. However, Telstra regarded that the level of 40 per cent mark-up was significantly lower than what is required to ensure continued investment in the route and to promote the LTIE.

Within the context of the 2015 DTCS FAD, Telstra considers that it is not only appropriate that the level of mark-up be re-examined but should be based on an analysis of access provider specific costs of supplying the submarine cable, and taking into account the geographically diverse path offered. At a minimum the level of mark-up should sufficiently capture higher cost factors associated with supplying undersea cables and to ensure continued future investment in routes to Tasmania.

3.2.12 Tail-end Services

The 2012 DTCS FAD set prices for standalone tail-end services. Telstra supported that it is appropriate that the price terms in DTCS FAD to apply only to tail-end services that are provided as standalone services. Telstra remains of the view that pricing for the 2015 DTCS FAD should again only apply only to tail-end services that are provided as stand-alone services and not to tail-end services that are bundled with other transmission services.

The methodology applied in the 2012 DTCS FAD for deriving pricing for tail-end service was on the basis of an unprotected service with an average distance of two kilometres was a reasonable and pragmatic approach. On principle, Telstra considers that such approach should apply to setting prices for stand-alone tail-end prices using the regression model in the context of the 2015 DTCS FAD.

¹⁴ ACCC Advice to Government: National Broadband Network Points of Interconnect, November p4.

4 Non-price terms for DTCS

The Commission is undertaking a separate consultation on the non-price terms and conditions and supplementary prices for all the declared services, including DTCS. Telstra has made a number of submissions to the Commission in response to the Position Paper published in May 2014. All Telstra's views in relation to non-price terms and conditions and supplementary prices are contained within those submissions.

4.1 Supplementary prices should be dealt with in conjunction with primary prices

Notwithstanding the separate submissions, Telstra notes its overall position that any supplementary prices should be dealt with in conjunction with the primary prices for each declared service. For DTCS, Telstra considers that the Commission should deal with supplementary prices together with the primary prices for DTCS – as was the case with the 2010-2012 DTCS FAD. Considering primary and supplementary pricing of DTCS within a single process ensures consistency between the pricing approaches, which consequently reduces the risk of regulatory error in setting either primary or supplementary prices.

In the 2010-2012 DTCS FAD, the Commission considered connection and disconnection charges for DTCS as part of the price terms process. As set out in Telstra's submission to the Commission's consultation on the non-price terms and conditions and supplementary prices for all the declared services, Telstra considers that the approach to determine DTCS connection charges is practical, as commercial pricing arrangements vary and it is in the LTIE for parties to have the flexibility to negotiate appropriate connection charges and discounts.

4.2 No requirement to include Special Linkage Charges

Telstra does not believe that the Commission should address Special Linkage Charges (**SLCs**) in DTCS FAD. SLCs are applied when the delivery of a transmission service requires capital expenditure to extend the Telstra network beyond what is funded as part of a standard installation. SLCs are cost-based charges directly proportionate to the cost of extending the network to accommodate the specific needs of the customer. As the scope of the infrastructure required to extend Telstra's network boundary point to the customer's point of presence will differ in each case, SLCs cannot be predicted in advance. Accordingly it is impractical to set *ex- ante* FAD prices.

Where an SLC is required to extend the network for the sole use of a wholesale customer, the entire charge is generally payable by the customer. If the length of the actual linkage required is less than estimated, the saving is passed on to the customer. If the length is more than estimated, the additional cost is not passed on to the customer. Where it can be reasonably assumed that the network extension will be utilised by other customers, the SLC may be apportioned appropriately or not charged, depending on the expected demand.

Telstra's retail business units have an analogous process. For example, enterprise customers are charged for network or infrastructure extensions required in order for Telstra to provide relevant services. Typically this is referred to as a capital contribution or Enterprise Contribution rather than a SLC.

Independent of any regulatory intervention and as part of its commitment to improving the customer experience, Telstra Wholesale conducted a trial between May and August 2014 with nine customers of an enhanced quoting tool with the goal of improving transparency and providing improved certainty of any applicable SLC. The trial saw reductions in the time taken to process the average request for a SLC from six weeks to 6 -10 days. Customer feedback from trial participants has been very positive. As the next step, Telstra is intending to review the lessons and outcomes from the trial with a view to refining its systems further to work towards a solution that can be rolled out more broadly to customers on a commercial basis.

The above demonstrates that SLCs (and related quoting processes) are able to be implemented, and where appropriate updated, effectively through normal commercial processes and channels. In addition to the practical difficulties associated with setting *ex ante* prices for SLCs, this suggests that there is no justification for regulation of these charges. Nevertheless, if the Commission is minded to consider SLCs as part of the FAD process, this should be done as part of the inquiry into primary DTCS prices in order to minimise the risk of regulatory error.

5 Access to facilities

Access to facilities is being considered by the Commission as part of its separate consultation on the non-price terms and conditions and supplementary prices for all the declared services, including DTCS. As noted above, Telstra has made a number of submissions to the Commission in response to the Position Paper published in May 2014.

However, in general Telstra believes that any regulation of facilities access through Part XIC of the CCA is unwarranted and would not be in the LTIE. Facilities access is already regulated through long established and well understood mechanism, specifically Parts 3 and 5 of Schedule 1 to the *Telecommunications Act 1997* (Cth). Further, if the Commission decides to regulate facilities access through the FADs for currently declared services, it would need to establish a direct nexus between the facilities access service and access to the relevant declared service: that is, the facilities access service would need to "relate to access" of the declared service.

Telstra's position on facilities access services is set out in more detail in its submission on supplementary prices.¹⁵

¹⁵ Telstra, Final Access Determination inquiry on supplementary pricing – Response to ACCC position paper, 15 July 2014.

6 Commencement and expiry

The Commission invites views on the appropriate time period for DTCS FAD, including appropriate commencement and expiry dates for the access determination and DTCS declaration.

Under the CCA, the Commission must include an expiry date in an access determination for a declared service. Further, unless there are circumstances that warrant a different expiry date, this should align with the expiry of the associated declaration. The current DTCS declaration expires on 31 March 2019 which suggests that a new DTCS FAD should also apply until that time.

In the Discussion Paper, the Commission notes that DTCS, and transmission services more generally, are provided in the market under contracts of different duration. The most recent information available to the Commission suggests that the most common duration for transmission contracts is 12 to 36 months. Contracts of shorter and longer terms are evident in the market but appear to be offered less frequently. The Commission also notes that DTCS customers may be on month-by-month arrangements in the interim period between contract negotiations.

If the expiry date is set in alignment with the expiry date for the declaration, this would result in a regulatory period for the 2015 DTCS FAD of just over four years. The Commission considers this period would be long enough to provide sufficient stability and certainty to support industry investment planning. However, the Commission also notes that, should prices change significantly, the price terms of DTCS could be reviewed subject to a variation inquiry.

DTCS market is characterised by a heterogeneous service that can be supplied in a variety of forms, using a variety of different technology interfaces, and by a number of different carriage service infrastructures. Due to the variety of DTCS services on offer, and the competitive nature of their supply, it is important that regulation continues to support an approach whereby all parties have sufficient flexibility to effectively negotiate a complex set of competitive commercial arrangements to meet end-user demand.

Telstra considers that proposals to shorten the FAD duration have the potential to distort current commercial negotiations away from longer term agreements. Regulatory and pricing stability is essential to innovation in product offerings and pricing constructs. Changes in regulatory settings can jeopardise such innovation, with even the risk of change having a similar impact. For example, some pricing innovations are predicated on price stability and would not emerge in a regulatory environment with short term or uncertain (that is, with a risk of variation) pricing reviews.

Overly frequent updating of regulated prices risks adversely impacting the current dynamic of the transmission market away from longer term service agreements and agreements (i.e. terms greater than 12 months). Longer term service agreements are an important feature of the market, where the access provider is trying to recover large up-front fixed costs. The reduction in risk associated with this cost recovery is reflected commercially in the subsequent discounts supplied to access seekers. Telstra notes that of its current DTCS services a significant number of services supplied are pursuant to longer term service agreements (i.e. 2-3 years).

Proposals to shorten the FAD duration or introduce mid-term price updates would also result in an asymmetric approach to regulation on exemptions and pricing. A principled approach to a mid-term price review mechanism would require exemptions to be considered either before, or at the same time as, a mid-term review. This is consistent with the approach taken in New Zealand in 2008 in relation the unbundled local loop access service. Here, the New Zealand Competition Commission (**NZCC**) made the assessment of competition and exemptions the subject of periodic review rather than the regulated prices set. Telstra considers that this is consistent with the view that increasing competition should lead to review of exemptions ahead of any regulated price change.

Telstra does not consider that there are any circumstances which warrant different expiry dates for DTCS declaration and FAD as required under the CCA. A new 2015 DTCS FAD should therefore align with DTCS declaration and apply until 31 March 2019.

Appendix 1: Response to Discussion Paper Questions

	Commission Question	Telstra Response
1	Does the domestic benchmarking approach continue to be an efficient and appropriate methodology for setting regulated DTCS prices? Please provide detailed reasons.	<p>Yes – Telstra considers that the domestic benchmarking approach continues to be the most efficient and appropriate methodology for setting price terms for DTCS.</p> <p>See Section 2.7 for further detailed reasons.</p>
2	Are there other methodologies that the ACCC should consider in determining a pricing model for setting regulated prices?	<p>No – In the context of DTCS, Telstra does not consider that alternative approaches – such as a forward-looking fully allocated cost (FAC) model or an historic cost-based Building Block Model (BBM) lead to materially better outcomes in seeking to set efficient pricing for DTCS.</p> <p>Telstra considers if the Commission was minded to adopt a cost-based approach it should be based on a forward-looking, TSLRIC+ methodology.</p> <p>See Section 2.8.</p>
3	Regarding a methodology identified in question 2, how does it address the criteria specified in subsection 152BCA(1) of the CCA?	<p>Telstra does not consider that alternative approaches will sufficiently satisfy the criteria that the Commission must have regard to under subsection 152BCA(1) of the Competition and Consumer Act (CCA).</p> <p>See Section 2.8.</p>
4	Regarding a methodology identified in question 2, how would it be applied (for example, with a fully allocated cost model) how would costs be allocated (including cost sharing factors) given transmission network characteristics?	<p>A comprehensive cost allocation framework would need to be established in order to set prices for multiple geographic areas, over multiple bandwidths and multiple distances across multiple providers.</p> <p>See Section 2.8.</p>
5	Regarding a methodology identified in question 2, what are the likely resourcing requirements needed to give effect to it?	<p>As recognised by the Commission, alternative approaches are likely to be significantly more complex and require significantly more resources than the benchmarking approach.</p> <p>See Section 2.8.</p>

	Commission Question	Telstra Response
6	Regarding a methodology identified in question 2, what are the information requirements needed to undertake a robust analysis?	A cost-based approach would require the collection of a significant amount of detailed cost information from all transmission suppliers. See Section 2.8.
7	Regarding a methodology identified in question 2, what are the likely methodology costs?	Alternative approaches are likely to have significant costs associated with the methodology through the need to establish an appropriate cost model and it will potentially impose higher regulatory costs for transmission service providers. See Section 2.8.
8	Regarding a methodology identified in question 2, explain how that approach is likely to provide a materially better outcome to the benchmarking approach.	Telstra does not consider that adopting alternative approach would provide a materially better outcome to the domestic benchmarking approach; therefore would not be in the LTIE. See Section 2.8.
9	What level of engagement by industry or independent experts would be necessary/appropriate for analysis of the pricing data in establishing the regression model for benchmarking DTCS prices?	Telstra considers that a collaborative approach (between the Commission, industry stakeholders and relevant independent experts) is beneficial to delivering successful outcomes in domestic benchmark approach for 2015 DTCS FAD. See Section 2.9.
10	What specific confidentiality safeguards are required to ensure that relevant experts have appropriate access to raw pricing data to assist the ACCC?	Telstra considers that appropriate confidentiality arrangements need to be in place to ensure that only the relevant experts have access to the confidential raw price data. See Section 2.9.
11	What changes to the 2012 DTCS FAD regression model should the ACCC consider in building the 2014 regression model to calculate benchmark prices for the 2015 DTCS FAD?	Telstra considers that the functional form of the 2012 DTCS FAD price regression model captures the underlying engineering and economics of DTCS. Therefore, Telstra considers this is a reasonable starting point for estimating prices for the forthcoming regulatory period. At this stage, Telstra is not advocating any significant changes to the regression model to calculate benchmark prices for DTCS. Rather, Telstra's view is that any changes to the model specification should be data driven and informed by robust econometric testing methods. See Section 3.

	Commission Question	Telstra Response
12	Which variables should the regression analysis focus on? Which variables should the regression analysis place less emphasis on and which should it disregard? Are there any additional variables that the ACCC should take into account in the model? Please provide reasoning.	<p>As stated above, Telstra supports the current functional form of the regression model. Employing new competitive data will further inform whether consideration needs to be given to changing any aspects to the underlying functional form of the model and any such changes would require careful consideration and should be informed by robust econometric testing methods.</p> <p>See Section 3.1.1.</p>
13	Should the ACCC focus on prices negotiated since the 2012 DTCS FAD in establishing pricing benchmarks or should the ACCC only focus on prices negotiated in 2014?	<p>Telstra's position is that the current stock of DTCS services currently supplied in competitive areas by all relevant service providers should be used for estimating price terms for the 2015 DTCS FAD.</p> <p>See Section 3.1.2.</p>
14	Should the ACCC reconsider the approach to selecting the benchmarked price point to use to set regulated prices? If so, which approach would be more appropriate and why?	<p>Telstra considers that the Commission should re-examine the range of price points from the regression model analysis to ensure the balance of risks is appropriate.</p> <p>See Section 3.1.5.</p>
15	Are there any other issues that the ACCC should consider when developing the model?	<p>Not at this stage, but Telstra suggests as industry stakeholder consultation on the development of the regression model and the outputs of the analysis come available that other issues are likely come to light.</p>
16	Is an approach that accounted for expected changes in price over time (that is, based on analysis of pricing data from 2011 to 2014 and projected forward into the next FAD period) appropriate for the next FAD?	<p>No – Telstra's position is that an estimation approach based on longitudinal data does not provide any account of future market demand or competition. Therefore, it is not legitimate to consider that it has predictive power for future outcomes in DTCS market. Consequently, Telstra sees no beneficial value in the application of this approach.</p> <p>See Section 3.1.3</p>
17	Alternatively, should the ACCC consider periodic re-pricing during the next FAD? If so, why? How frequently should the ACCC consider re-pricing and should it be automatic or a full review?	<p>No - Telstra considers that periodic re-pricing during the FAD has significant risks and gives rise to unnecessary regulatory intervention.</p> <p>See Section 3.1.4.</p>

	Commission Question	Telstra Response
18	Should the pricing of services over the SDH interface be considered separately from Ethernet services?	Telstra proposes that further examination of different technology interfaces should be undertaken in the context of the regression model analysis. See Section 3.2.1.
19	Should the ACCC maintain the approach to incorporate a variable for 'protection' in the regression model?	Yes - Telstra advocated for protection as an explanatory variable within the 2012 DTCS FAD regression model, as it is an important and key differentiator for DTCS in the market. See Section 3.2.2.
20	What is the minimum form of protection required for a DTCS service?	Telstra considers that the minimum level of protection should be determined by geographic path diversity in the inter-exchange component of a transmissions service only. See Section 3.2.2.
21	Is quality of service sufficiently reflected in the 2012 DTCS FAD regression model?	Yes - Telstra continues to support the inclusion of a quality of service variable to account for the differences in quality of service between providers and setting prices on the basis of the highest quality of service. See Section 3.2.3.
22	If so, should the ACCC maintain the same approach in the next FAD? What are the benefits and costs of maintaining the same approach?	Telstra's position is that the 2012 DTCS FAD approach of accounting for quality of service remains relevant, and should not necessarily change for the 2015 DTCS FAD. See Section 3.2.3.
23	If not, how should quality of service be incorporated into the regression model?	NA
24	Are the route categories of inter-capital, metropolitan and regional relevant for the next FAD?	Telstra considers that three route categories of inter-capital, metropolitan and regional remains relevant for the upcoming 2015 DTCS FAD. See Section 3.2.4.
25	Should the ACCC consider adopting a route type matrix approach for pricing in the next FAD?	No – Telstra's considers that current form of the regression model can account for any differences in route type matrices.

	Commission Question	Telstra Response
		See Section 3.2.4.
26	Are there any alternative approaches to the existing route categories or Telstra route type matrix that balance transparency and simplicity with a higher level of cost reflectivity?	No – Telstra's supports the current three route categories. See Section 3.2.4.
27	Should the ACCC continue with its approach to the distance variable in the regression analysis?	Yes - Telstra considers that the use of radial distance remains the most appropriate distance measure within the regression model. See Section 3.2.5.
28	Should the ACCC consider using a route type matrix in deriving DTCS pricing from the regression model?	Telstra considers that decisions regarding changes to deriving DTCS pricing are best left until the regression model analysis are known.
29	What range of capacities should the ACCC price?	Telstra suggests that a reassessment is required on the number of services at higher capacity before the threshold of 622Mbps is removed. See Section 3.2.6.
30	Should the range of capacities for which the FAD prices apply be reviewed during the term of the next FAD?	No – Telstra considers regulatory stability and certainty is required in price setting terms in 2015 DTCS FAD. See Section 3.2.6.
31	To what extent should the regression analysis focus on contract length?	Telstra's notes that contract length is embedded in the billing price data provided. However, Telstra considers that decisions regarding changes to regression model are best left until the new competitive price data is supplied and regression model analysis are known.
32	Should the ACCC continue to price DTCS for a contract period of 12 months in the next FAD? If not, what term period should be considered and what are the costs and benefits of an alternative approach?	Telstra considers that the price setting terms based on contract period of 12 months remains for the 2015 DTCS FAD. See Section 3.2.7.
33	How should the ACCC take into consideration the effect of term and/or whole-of-business discounts in setting DTCS prices in the next FAD?	Telstra notes all service specific and service term related prices is captured in the billing price data provided as part of the 2012 DTCS FAD.

	Commission Question	Telstra Response
		See Section 3.2.8.
34	Which of the discounts, which are made available as part of commercial negotiations, should be taken into account in the regression analysis?	None – Telstra's consider that term discounts are fully accounted in the data provided for the regression analysis and it would be inappropriate to specifically incorporate or account for whole of business discounts. See Section 3.2.8.
35	Should the regression analysis consider the level of demand (reflected by some measure such as a combination of population density and services in operation) as a variable in the analysis?	Telstra proposes that further examination of demand or utilisation using a variety of proxies should be undertaken in the context of the regression model analysis. See Section 3.2.9.
36	Should some other account of demand be included in the regression analysis?	See above.
37	Should the pricing of tail-end services as a stand-alone product be revised to reflect the market practice of bundling?	No - Telstra remains of the view that pricing for the 2015 DTCS FAD should again only apply only to tail-end services that are provided as stand-alone services. See Section 3.2.12.
38	Should pricing on deregulated NBN POI routes be considered separately in undertaking the regression analysis for the next FAD?	No – Telstra's position is that DTCS serving POI does not warrant differential treatment within the regression model. See Section 3.2.10
39	Should the 2015 DTCS FAD maintain an uplift on pricing to Tasmania to reflect the higher costs associated with the route? If so, does 40% remain appropriate?	Telstra considers that an uplift is required to account for the higher costs of supplying the submarine cable and that the level of mark-up should be re-examined in the context of the 2105 DTCS FAD. See Section 3.2.11.
40	What is an appropriate time period for the next FAD?	Telstra's position is that a new DTCS FAD should align with the DTCS declaration and apply until 31 March 2019. See Section 6.

	Commission Question	Telstra Response
41	Are there any circumstances that warrant a difference in the expiry dates of the access determination and DTCS declaration?	No – Telstra does not consider that there are any circumstances that would necessitate a different DTCS FAD expiry date and DTCS declaration date. See Section 6.
42	If price terms of DTCS are reviewed during the course of the FAD term, what would be an appropriate period in which such a review should take place?	Telstra position is that mid-term review is inappropriate in the context of the 2015 DTCS FAD and poses significant risk to incentives and regulatory stability. See Section 6.