



# **FINAL ACCESS DETERMINATION: THE DOMESTIC TRANSMISSION CAPACITY SERVICE**

Submission in  
response to the  
ACCC's draft decision

PUBLIC VERSION

9 October 2015



# 1 Executive Summary

VHA welcomes the opportunity to comment on the ACCC's draft final access determination (**FAD**) for the Domestic Transmission Capacity Service (**DTCS**) dated 4 September 2015 (**draft FAD**) and Economic Insights' (**EI**) final report on the DTCS benchmarking model dated 1 September 2015 (**Final Report**). The ACCC's objective in determining regulated DTCS prices must be to replicate, as far as possible, the outcomes of a competitive market. Accordingly, regulated prices should be as close as possible to the efficient cost of providing the service over the relevant time period. VHA submits that a number of aspects of the draft FAD are inconsistent with this objective. In particular, VHA wishes to raise three significant concerns in relation to the ACCC's draft FAD. These concerns must be adequately addressed by the ACCC if its FAD is to be consistent with the statutory criteria and promote the objects of Part XIC of the *Competition and Consumer Act 2010*.

First, unless the consistent downward trend in undeclared transmission pricing is reflected through dynamic pricing over the term of the FAD, FAD pricing is likely to be approximately 65% above actual pricing on undeclared transmission routes. VHA submits that a conservative approach to address this issue would be to implement a 10% decrease in prices each year over the term of the FAD.

Second, in EI's modelling exercise, the identity of the service provider has been identified as a significant determinant of price. In this context, the adoption of the median value of provider effects (an approach that is explicitly not advocated by EI) is entirely inconsistent with the objective of benchmarking **efficient** prices. The ACCC must consider adopting the provider effect value of the lowest cost provider of any scale as recommended by Professor Bartels in his report dated 7 October 2015 (**October 2015 Report**).

Third, Synchronous Digital Hierarchy (**SDH**) technology is already quite outdated and significantly less cost efficient than Ethernet. On this basis, VHA supports the ACCC's proposal of setting regulated prices by reference solely to services using the Ethernet interface. To do otherwise, would likely set extremely poor incentives for access providers by encouraging the use of legacy SDH technologies even if Ethernet interfaces are available.

In addition to addressing these concerns VHA submits that the ACCC should consider:

- adopting regulated pricing below the mean predicted value in order to address some of the concerns about the data set that have previously been raised; and
- specify a non-price term requiring Telstra to break down its charges for the MLL into declared and non-declared cost components. This will improve transparency, efficiency and clarity in the pricing of MLL services whilst retaining the commercial freedom for stakeholders to depart from FAD pricing by agreement. Without this change there will be real challenges in terms of implementing the FAD in relation to MLL services.

While VHA assumes there will be a further round of consultation on the how the eJV data should be reflected in the FAD to ensure that stakeholders have an opportunity to review and comment upon the ACCC's approach, it requests that the ACCC ensure that the FAD is not further delayed as a result. The current FAD, which the ACCC acknowledges to be inadequate, has remained in force for 18 months beyond its expiry date. It is imperative that the ACCC make its new FAD before Christmas.



Australia suffers from one of the most distorted telecommunications markets in the developed world. In the mobiles market we see robust mobiles competition but regional Australians are missing out on adequate coverage and effective choice. A central impediment has been inadequate access to monopoly backhaul services. This has protected the vertically integrated incumbent from competition and this means Australia is being held back from the full benefits from the digital and mobile revolutions. It is therefore essential that the ACCC finalise as soon as possible efficient cost reflective pricing for monopoly backhaul services.

These submissions should be read in conjunction with Professor Bartels' July 2015 Report and his October 2015 Report (Annexure 1).

## 2 Pricing over the duration of the FAD

Regulated pricing will best promote the long term interests of end users (LTIE) when they are forward looking. For example, in *Telstra Corporation Ltd (No 3)* [2007] ACompT 3, the Australian Competition Tribunal (Tribunal) affirmed the ACCC's decision to reject Telstra's unconditioned local loop service (ULLS) undertakings in part because Telstra's network costs were not a reasonable estimate of its projected costs for the period covered by the undertakings. In particular, the Tribunal stated that the historic costs put forward by Telstra were based on Telstra's actual costs, not the forward-looking efficient costs of providing the ULLS.

In other regulated industries such as gas and electricity the Australian Energy Regulator (AER) and the Essential Services Commission (ESC) implemented downward adjustments to the base year operating expense<sup>1</sup> and to benchmarks respectively to address ongoing efficiencies<sup>2</sup>. In particular, the ESC gave consideration to the observed declining trend in pricing and stated that, in the absence of evidence that efficiencies have been exhausted, a downward trend should continue to apply to benchmarks.<sup>3</sup>

A key issue with the draft FAD is the ACCC's failure to address the continuation of the significant downward trend in undeclared transmission pricing over the term of its draft FAD, despite strong evidence that efficiencies have not been exhausted. As identified by Professor Bartels in his October 2015 Report, it is reasonable to assume a decline of 10% per year in undeclared transmission pricing over the duration of the FAD. The ACCC's decision not to take account of this trend is effectively a decision that a 0% decrease in undeclared transmission pricing over the entire term of the FAD is its best estimate of the future trend in prices. This is in sharp contrast with Professor Bartels' finding that, unless the consistent downward trend in undeclared transmission pricing is reflected through dynamic pricing over the term of the FAD, FAD pricing is likely to be approximately 65% above actual pricing on undeclared transmission routes by the end of the FAD period.<sup>4</sup> The ACCC's approach is manifestly unreasonable and flies in the face of the evidence before it (including from its own consultant EI)<sup>5</sup> that reductions in pricing over time have been and will continue to be significant.

---

<sup>1</sup> Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs- report prepared for the AER*, 17 November 2014

<sup>2</sup> Essential Services Commission, *Gas Distribution System Code – Review of Unaccounted for Gas Benchmarks – Final Decision*, June 2013

<sup>3</sup> Essential Services Commission, *Gas Distribution System Code – Review of Unaccounted for Gas Benchmarks – Final Decision*, June 2013, page 4

<sup>4</sup> Bartels, October 2015 Report (redacted version), page 2

<sup>5</sup> EI, Final Report, page 33



Such an approach is also inconsistent with decisions of the Tribunal and out of step with the ACCC's peer regulators. It also inconsistent with the ACCC's responsibility to exercise regulatory discretion and make decisions which best promote the LTIE. As the ACCC is well aware, the LTIE will be promoted where regulated pricing is forward looking and efficient.

The ACCC's draft FAD is based on 2014 pricing data which, in the absence of an upfront adjustment, will mean that the FAD will already be more than 1 year out of date once it is finalised. It is then intended to run for a further 4 years until the end of 2019. In this context, it is not sufficient for the ACCC to simply reject dynamic pricing, as it does in its draft FAD, because no appropriate method has been identified to date.<sup>6</sup> Particularly in circumstances where it (in the context of the MTAS) and other similar regulators have routinely included a downward adjustment in their pricing determinations. Based on the information before it, and Professor Bartels' analysis (that without an adjustment regulated prices will be 65% higher than actual unregulated prices), a conservative approach would be to implement an annual 10% downward adjustment. This would allow the ACCC to be confident that the legitimate business interests of access providers would be protected.

If there is any residual concern about this issue, the ACCC could adopt its proposal of using its section 151BU or section 155 powers to collect data from service providers so as to enable it to ensure that regulated prices do not drop below unregulated prices for some unforeseen reason. VHA submits that the regulatory burden on service providers would not be too significant and this would allow it to satisfy itself that any downward glide-path over the term of the FAD would not result in pricing that is below the efficient cost of supply.

### 3 Lower cost service providers

EI has indicated that the service provider variable is a significant determinant of price<sup>7</sup> and considers that this may reflect differences in efficiency and/or market power.<sup>8</sup> In its final model, it elected to use a collective service provider indicator variable and, to illustrate the use of its benchmarking model, it selected the median value of the provider effects (which also equates to the largest provider). However, EI makes it clear it is not asserting that this value should necessarily be adopted.<sup>9</sup>

Although the ACCC does not explain its reasoning in the draft FAD, it implicitly supports the adoption of the median value of provider effects by endorsing EI's proposed model without relevant changes. VHA submits that this approach is inconsistent with the objective of benchmarking the efficient costs of providing the service and that one of the lower cost providers should be used, for example, the third lowest provider, as recommended by Professor Bartels in his October 2015 Report.<sup>10</sup>

As indicated by Professor Bartels, there are no strong grounds for choosing the median provider over the lowest provider at scale and, in selecting the more efficient provider, the ACCC could correct for any residual non-competitive effects.

---

<sup>6</sup> ACCC, DTCS Draft FAD, page 28

<sup>7</sup> ACCC, DTCS Draft FAD, page 4

<sup>8</sup> EI, Final Report, page 50

<sup>9</sup> EI, Final Report, page 53

<sup>10</sup> Bartels, October 2015 Report (redacted version), page 3





Moreover, adopting this approach is more consistent with that recently adopted by the AER for electricity distribution (it chose the fifth lowest cost provider out of 13).<sup>11</sup>

## 4 Interface type

Ethernet technology is newer technology and is increasingly used in preference to SDH technology which is now quite outdated. More importantly, SDH technology is significantly less cost efficient – as stated by the ACCC in its draft FAD, “assuming all other variables are held constant, the SDH is estimated to increase the monthly DTCS price by approximately \$198 above the price of Ethernet”.<sup>12</sup> In this context, VHA strongly supports a benchmark model based on Ethernet services only.

Promotion of the LTIE requires the ACCC to consider whether the access determination will encourage the economically efficient use of, and investment in infrastructure.<sup>13</sup> Economic efficiency includes dynamic efficiency (which is “the need for industries to make timely changes to technology... in response to changes in consumer tastes and in productive opportunities”<sup>14</sup>) and allocative efficiency (that resources should be allocated to their highest valued uses).<sup>15</sup> SDH is a legacy technology which is inefficient and outdated and its use does not promote dynamic or allocative efficiency. Moreover, inclusion of SDH services in the in the ACCC’s preferred model is not a sound basis for setting forward-looking regulated prices.

For these reasons, VHA submits that the ACCC should benchmark against Ethernet services only in determining regulated DTCS pricing.

## 5 The mean predicted value should not be adopted

The ACCC appears to have decided not to adopt regulated pricing below the mean predicted value because EI found that there is no statistical basis for doing so.<sup>16</sup> Regardless of whether the ACCC agrees with EI’s conclusion, it is the ACCC’s task to determine pricing based on its knowledge and understanding of the market, not purely on statistical grounds. It must also act in a way that promotes the LTIE, an obligation EI does not have. This means that the ACCC cannot simply follow EI’s statistical modelling. There is ample evidence before the ACCC that it could readily set pricing below the mean predicted value without risking efficient investment in infrastructure or the legitimate business interests of DTCS providers. Specifically we know that:

- most observations in the ACCC data set did not include adjustments for applicable discounts and rebates;<sup>17</sup>

---

<sup>11</sup> EI, *Response to Consultants’ Reports on the Economic Benchmarking of DNSPs*, 22 April 2015, page 66; AER, *Final Decision: Ausgrid Distribution Determination 2015-16 to 2018-19, Overview*, April 2015, page 41

<sup>12</sup> ACCC, DTCS Draft FAD, page 24

<sup>13</sup> Subsection 152AB(2) of the CCA

<sup>14</sup> ACCC, DTCS Draft FAD, page 70

<sup>15</sup> ACCC, DTCS Draft FAD, page 70

<sup>16</sup> ACCC, DTCS Draft FAD, page 31

<sup>17</sup> The ACCC in its Draft FAD (at page 28) states that “the majority of service providers were unable to provide detailed information on which discounts applied to each contract”. Similarly, the ACCC in its Explanatory Note (at page 3) stated that “Most providers were unable to supply information regarding discounts or rebates provided to customers”



- if you assume that transmission services are not ordinarily provided below cost, the inherent volatility in the data whereby services with ostensibly identical characteristics are provided at vastly different prices is strongly indicative of the mean price being substantially above cost;<sup>18</sup> and
- zero price observations were removed from the data set.

If the ACCC does not adopt pricing that is below the mean, the FAD will not reflect the efficient cost of supply and could allow providers on declared DTCS routes to continue to obtain monopoly rents.

## 6 Telstra's Managed Lease Line (MLL) services

VHA welcomes the ACCC's clarification that Telstra's MLL service is a declared service. VHA also agrees with the ACCC's view that there is a lack of clarity around the current MLL pricing matrix.

Ultimately, there is a need for a simplified approach that allows access seekers to rely on the terms of the FAD in commercial negotiations for the acquisition of MLL services (or at least those components of the MLL service that are declared). To achieve this outcome, VHA proposes that the ACCC specify a non-price term requiring Telstra to break down its charges for the MLL into declared and non-declared cost components. This will improve transparency, efficiency and clarity in the pricing of MLL services whilst retaining the commercial freedom for stakeholders to depart from FAD pricing by agreement. Without this change there will be real challenges in terms of implementing the FAD in relation to MLL services, contrary to the LTIE

## 7 Consideration of additional data

Pricing data from the Optus/VHA joint venture (eJV) is not yet reflected in any way in EI's modelling or the ACCC's draft FAD. VHA acknowledges the ACCC's stated intention to take this data into account in some way and assumes that stakeholders will have a brief opportunity to review and comment upon the way in which this is done.<sup>19</sup> However VHA would be extremely concerned if this or any other new issue were to delay making of the FAD until after Christmas. The current FAD, which contains regulated pricing which vastly exceeds efficient costs, has continued in force for 18 months beyond its intended expiry date. To allow this state of affairs to continue beyond Christmas would not promote the LTIE.

If the ACCC is unable to resolve the issues around the eJV data before Christmas, it should go ahead and make the FAD and vary it as required in the new year. Otherwise its commercial utility will be severely diminished as current contracts will have to be extended.

---

<sup>18</sup> Bartels, *Use of ACCC Dataset for DTCS Benchmarking*, April 2015 (redacted version), pages 8 and 14

<sup>19</sup> ACCC, DTCS Draft FAD, page 29



## Annexure 1