

**SUBMISSION ON THE DRAFT DETERMINATION FOR MODEL PRICE TERMS AND
CONDITIONS OF THE PSTN, ULLS AND LCS SERVICES**

A INTRODUCTION

1 On 18 June 2003, the Australian Competition and Consumer Commission (“**Commission**”) released a “*Draft Determination for model price terms and conditions of the PSTN, ULLS and LCS Services*” (“**the Draft Determination**”). The Commission has invited industry participants to provide their views on the Draft Determination.

2 This Submission sets out Telstra’s views on various matters in the Draft Determination.

3 Telstra’s “*Submission in Relation to the Methodology used for Deriving Prices Proposed in its Undertakings*” dated 13 February 2003 (“**the Methodology Submission**”), and Telstra’s “*Detailed Submission in Support of its Undertakings dated 9 January*” (“**the Detailed Submission**”) are to be read in conjunction with, and form part of, this Submission. This is because Telstra’s position on various matters raised in the Draft Determination is further canvassed in the Methodology Submission and in the Detailed Submission. The Methodology Submission and the Detailed Submission include their respective annexures.

B SUBMISSION

4 In addition to the matters set out in the Methodology Submission and the Detailed Submission, Telstra makes the following comments in respect of the Draft Determination. References are to headings and sections in the Draft Determination.

5 Defined terms in the Detailed Submission and in the Draft Determination have the same meaning in this Submission, unless otherwise indicated. Headings in the Draft Determination are used in this Submission.

C CONFIDENTIALITY

6 The following information in this Submission is confidential to Telstra and may only be disclosed by the Commission to persons approved of in writing by Telstra who have signed confidentiality undertakings which are acceptable to Telstra.

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Section	Paragraph	Information
F2 - WACC	31	All figures in Table 1
G - PSTN - THE ACCESS DEFICIT CONTRIBUTION	55	All figures in Table 2
G - PSTN - THE ACCESS DEFICIT CONTRIBUTION	57	“c-i-c”
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I2 - Commission’s views on ULLS-specific costs	106	All figures in Table 3

D EXECUTIVE SUMMARY (section 1)

- 7 In the Undertakings, Telstra has proposed prices for PSTN OTA, LCS and ULLS (the UT Services) for the 2002/03, 2003/04 and 2004/05 years which Telstra believes conform with the legislative criteria, are reasonable and ought to be accepted by the Commission. The bases for Telstra’s belief are set out in the Detailed Submission.
- 8 Telstra therefore encourages the Commission to set price points (or if the Commission is so inclined, price ranges) in accordance with the Undertaking Prices set out in the Detailed Submission.
- 9 It follows that the model or indicative non-binding prices in relation to the UT Services contained in the Draft Determination, to the extent that they are below the Undertaking Prices, are inappropriate and should not be included in any final determination by the Commission.
- 10 Telstra does not agree with the Commission’s comments concerning the ADC (or, as it is referred to in the Detailed Submission, the UPCC). Telstra’s views in relation to the UPCC are set out in the Detailed Submission and further below.

E MODELLING FRAMEWORK (section 6)

E1 The appropriate model (section 6.1)

11 The Commission states that the n/e/r/a model is a TSLRIC model, and speculates as to whether there may be differences between the basic nature of the n/e/r/a model and the PIE II model, which is a TELRIC model.

12 A full explanation of the PIE II model is set out in the Methodology Submission, in sections G and H of the Detailed Submission, and in the Mitchell Report.

13 The n/e/r/a model is not a true TSLRIC model. Rather, like the PIE II model, it is a TELRIC model. By a “TELRIC model”, Telstra is referring to a model which determines the elements needed to build a PSTN and costs those elements. The unit costs of network elements (ie TELRIC) are then multiplied by the routing factors for the service at issue to arrive at the unit cost of the service (ie TSLRIC). As explained in the Detailed Submission, a TELRIC model enables the estimation of TSLRIC by simplifying the allocation of common costs.

14 In broad terms, both the n/e/r/a model and the PIE II model approach the problem of determining the TSLRIC for PSTN in a similar conceptual manner. However, the PIE II model is considerably more sophisticated in terms of the nature of input data used and the attempt to reflect real world network implementation.

15 In addition, the PIE II model incorporates more services than n/e/r/a, and therefore captures a higher degree of economies of scale and scope than n/e/r/a. Therefore, the n/e/r/a model is more “stand-alone” in nature than the PIE II model. Telstra contends that by including all services that use the copper CAN and PSTN, the PIE II model provides a least-cost estimate of the UT Services, as it includes a much larger increment in its costing.

E2 Applying an adjustment factor (section 6.2)

16 Telstra agrees with the Commission’s view that use of the PIE II model means that an adjustment factor to update prices in future periods is not necessary.

E3 Price ranges or points (section 6.3)

17 In the Draft Determination, the Commission states that it considers both price ranges and price points to have merit, depending on the specific circumstances.

- 18 In Telstra’s view, given that the Commission will have received submissions from all interested parties on the Draft Determination and should have finalised its views on pricing methodology (including the PIE II model) at the close of the consultation period, it would be appropriate and preferable for the Commission to release indicative price points rather than ranges of indicative prices.
- 19 Telstra considers that the publication of price points would be more likely to facilitate commercial negotiations by providing guidance on what the Commission believes to be fair price terms and conditions of access to a particular service. Contrary to the submissions of AAPT and Optus cited by the Commission in the Draft Determination, Telstra believes that price ranges may hinder or complicate negotiations. Telstra also sees little merit in the Commission attempting to give “guidance” as to the factors that might decide a point within a range, as suggested by Optus, as such factors would be extremely difficult to identify with precision or exhaustively given the array of circumstances which might apply.
- 20 Further, Telstra submits that the price points set by the Commission should be the Undertaking Prices, for the reasons set out in the Detailed Submission. If, notwithstanding this Submission, the Commission remains inclined to set price points for the UT Services within the ranges set out in the Draft Determination, Telstra encourages the Commission to determine price points at the upper end of those ranges.
- 21 In the event that the Commission, notwithstanding this Submission, remains inclined to set indicative price ranges, Telstra encourages the Commission to determine ranges having regard to the Undertaking Prices, or to determine a narrow range at the upper end of the ranges set out in the Draft Determination.

F APPROPRIATE INPUTS (section 7)

F1 Trench sharing (section 7.1)

- 22 The Commission states that the scorched-node methodology dictates that the level of trenching in new estates should reflect Telstra’s previous ability to share trenches in new estates, and its ability to share over the regulatory period. In this regard, the Commission proposes that the PIE II model reflect the assumption that new estates make up around 13% of Telstra’s network.

- 23 The Commission’s proposal that the PIE II model should reflect the assumption that 13% of Telstra’s network is comprised of new estates (which is said to be based on conservative estimates over the last 10 years), and that therefore the PIE II model should exclude 13% of trench costs, is manifestly unjustifiable and incorrect for a number of reasons. In particular:
- (a) it is incorrect to assume a cumulative figure of 13% on the basis that trenches opened during the last 10 years could be shared with third parties. Trench sharing requires that both parties are building the infrastructure at the same time, and as TSLRIC models the network at the beginning of each year, it follows that it is only appropriate to use trenches open at that time;
 - (b) such a high figure is an inappropriate input for the PIE II model, as the trench sharing factor is applied to all ESAs in the network, regardless of their location or characteristics. It is clearly unreasonable to assume that 13% of CBD inner metropolitan distribution trenching ever formed part of any “new estates” development arrangement. Similar arguments apply for much of the rural and remote network, which do not have any significant “new estate” developments in the sense that the Commission is using. For inputs of up to a few percent the model will give reasonable estimates of the impact of trench sharing, but extending this factor beyond 5% is outside the scope of the underlying assumptions on which the model is constructed, and would not produce reasonable results, for the reasons outlined above; and
 - (c) the Commission has provided no empirical evidence in support of the assertion that over a 10 year period, 13% of the services provided in 2002/03 would be estates that could be assumed to be or have been new estates. Nor does the Commission give any explanation as to why 10 years is a relevant period for present purposes.
- 24 Further, Telstra does not see the relevance of “scorched node” vs “scorched earth” to this issue. In both approaches, the CAN is optimised at a point in time, with the only potential difference being the location of the RAUs. The potential for trench sharing remains the same under both approaches, which the Commission identifies correctly in the case of scorched earth as being the level of trenching in new estates in a given year. As the PIE II model already optimises the location of RAUs remote from exchange buildings, and also sites the exchange building in the Telstra building in the most teledense region of an ESA,

it is clear that in terms of the CAN, the PIE II model is already closer to scorched earth than scorched node, and that by the Commission's arguments, the single year figure of 1% is an appropriate estimate of the potential for trench sharing.

25 The single year figure is also consistent with the Commission's interpretation of TSLRIC. According to the Commission's 1997 "*Pricing Principles for Telecommunications*", an access price based on TSLRIC is consistent with the price that would prevail if the access provider faced effective competition, and usually best promotes the long term interests of end users. In a competitive market, the price that would prevail would be equal to the cost that would be incurred by an efficient service provider deploying its network today. An efficient network operator deploying its network today would not be able to share its trenches with other utilities in 13% of its network. Rather, the trench sharing opportunities available to an efficient network provider today, and hence the costs that such a provider would incur, would be limited to the new estates in the period of network deployment.

26 In addition, the Commission's assumption appears completely at odds with its assumption that the costs actually incurred by Telstra in the past are irrelevant to the estimation of TSLRIC. It would seem indefensible to suggest that actual trench sharing opportunities that may have been available over the past 10 years should be taken into account when determining the cost of the UT Services, but the costs that Telstra actually incurred in the same historical period in the provision of services over its legacy network are irrelevant.

27 Accordingly, Telstra rejects the Commission's proposal that 13% of trenches would be available for third party trench sharing.

28 Telstra refers to sections H7 and H8 of the Detailed Submission which set out Telstra's position in relation to trench and duct sharing with others. For the reasons there stated, the exclusion of 1% of trench costs from the PSTN cost pool is appropriate.

F2 WACC (section 7.2)

29 Telstra refers to section H9 (and related Annexures) of the Detailed Submission, where Telstra's position on the WACC and its component parameters is fully detailed.

30 Telstra disagrees with the continued use by the Commission of a number of the WACC inputs which the Commission adopts from its assessment of Telstra's second PSTN undertaking.¹ These areas of disagreement are set out below:

- (a) The MRP adopted by the Commission is not representative of estimates typically used in Australia based on historical estimates. Nor is it valid from a forward-looking perspective recognising the relatively recent integration of Australian capital markets. Moreover, the estimate of the MRP does not appear to have been re-calibrated with the maturity of the risk-free investment.
- (b) The asset beta recommended by the Commission is too low relative to empirical estimates for the RBOCs, the best listed analogue for the PSTN-only provider, especially recognising recent factors biasing downward empirical estimates as well as the likely higher operating leverage of the PSTN-only provider.
- (c) Telstra does not consider that the Commission justifies its adoption of the undertaking period to define the maturity of the risk-free investment in a situation where regulatory intervention is not necessary. Given this, there is limited potential for the regulator to insulate the PSTN provider from future interest rate or inflation risk or to ensure a pre-determined *ex ante* return on investment is achieved *ex post*. There are also conceptual difficulties associated with applying a WACC based on a short maturity Government bond in a levelising context over the life of the asset.
- (d) The debt risk premium adopted by the Commission is not justified and is low relative to empirical information at the Telstra-wide level.
- (e) The Commission does not justify the adoption of an effective tax rate from a theoretical or empirical perspective, especially given that accelerated depreciation (the major historical factor lowering effective rates of tax from the statutory rate) is not available or relevant in a TSLRIC new-build perspective for the access provider (buy decision) or the access seeker (build decision).
- (f) The gearing adopted by the Commission does not appear based on market values as required in WACC estimation to identify contemporary opportunity costs.

¹ ACCC, *A Report on the Assessment of Telstra's Undertaking for the Domestic PSTN Originating and Terminating Access Services*, July 2000.

31 For the reasons set out in the Detailed Submission, Telstra submits that the appropriate WACC parameters and WACC which should be adopted by the Commission are as set out in Table 1.

Table 1: Appropriate WACC parameters and WACC

Parameter	2002-03	2003-04	2004-05
Risk-free rate	“c-i-c”	“c-i-c”	“c-i-c”
Debt risk premium	“c-i-c”	“c-i-c”	“c-i-c”
Debt Issuance Costs	“c-i-c”	“c-i-c”	“c-i-c”
Cost of Debt Pre-tax	“c-i-c”	“c-i-c”	“c-i-c”
Debt beta	“c-i-c”	“c-i-c”	“c-i-c”
Asset beta	“c-i-c”	“c-i-c”	“c-i-c”
Gearing	“c-i-c”	“c-i-c”	“c-i-c”
Equity Beta	“c-i-c”	“c-i-c”	“c-i-c”
Market Risk Premium	“c-i-c”	“c-i-c”	“c-i-c”
Imputation factor	“c-i-c”	“c-i-c”	“c-i-c”
Corporate tax rate	“c-i-c”	“c-i-c”	“c-i-c”
Cost of equity after tax	“c-i-c”	“c-i-c”	“c-i-c”
Nominal Post-tax "Vanilla" WACC included in undertaking	“c-i-c”	“c-i-c”	“c-i-c”
Equity issuance costs	“c-i-c”	“c-i-c”	“c-i-c”
Cost of equity after tax including equity issuance costs	“c-i-c”	“c-i-c”	“c-i-c”
Nominal Post-tax “Vanilla” WACC including equity issuance costs	“c-i-c”	“c-i-c”	“c-i-c”

F3 Network planning costs (section 7.3)

32 The Commission has stated that it does not propose to allow network planning costs in the PIE II model as it considers these costs to be inconsistent with the principles of TSLRIC using a scorched node approach.

33 For the reasons set out in section H14 of the Detailed Submission, network planning costs must be included in the PIE II model and in the calculation of the costs which would be incurred by an efficient operator of the PSTN who had to rebuild the network.

- 34 Telstra does not understand the Commission’s criteria or reasoning for determining that network planning is not a TSLRIC expense. In this regard, Telstra refers to the Mitchell Report, where Dr Bridger Mitchell explains the importance of network planning and designing in a scorched node TSLRIC network. Further, Telstra notes that network planning costs have traditionally been recognised by TELRIC models in the form of the application of an “uplift factor” to the cost of each individual network component.
- 35 Without network planning activity, it is not possible for any access seeker to build an efficient, best in use network. Furthermore, as the network is constantly evolving, it is essential that planning be undertaken to ensure that the necessary changes happen when required. Network planning is a cost associated first with the deployment and building of the assets and then the ongoing maintenance and replenishment of the infrastructure. As such, it is an essential activity required to ensure that the infrastructure operates effectively and efficiently. There is no reason to exclude these costs from being a reasonable expense incurred by any operator.
- 36 Telstra also does not understand how the inclusion of network planning costs could be inconsistent with a scorched node approach to TSLRIC. The scorched node approach is adopted as a practical modelling methodology and involves modelling the efficient network architecture given the location of nodes as in the legacy network. Such a methodology, used for the purposes of practical implementation, has no implications for the inclusion of network planning costs which, as discussed above, are consistent with the costs that would be incurred by an efficient operator. Excluding these costs from PSTN OTA prices would result in prices below that which would prevail in a competitive market.
- 37 Telstra urges the Commission to change its view on network planning costs, and allow for such costs in determination of an efficient TSLRIC rate in accordance with section H14 of the Detailed Submission.

G PSTN - THE ACCESS DEFICIT CONTRIBUTION (section 8)

- 38 Telstra’s position in relation to the ADC (or UPCC) is set out in section E of the Detailed Submission and in the UPCC Submission (which is Annexure F to the Detailed Submission) and in certain other Annexures to the Detailed Submission.
- 39 For the reasons there stated, Telstra submits that:

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- (a) in accordance with a UPCC allocation approach based on usage, access seekers who use and benefit from the CAN infrastructure, should be allocated responsibility for contributing to its overall costs; and
- (b) the UPCC should not be eliminated until the AD is eliminated.

40 Telstra is disappointed by the Commission's current views regarding the UPCC as stated in the Draft Determination. Telstra invested substantial time and effort in preparing its response to the February Discussion Paper, yet the Commission fails to address the primary arguments made by Telstra in the UPCC Submission. The UPCC Submission details the reasons why access seekers should make a contribution to the UPCC in PSTN OTA prices.

41 Rather, the Commission selectively notes responses made by Telstra in the UPCC Submission and appears to discount Telstra's views for no other reason than Telstra being the only respondent to the February Discussion Paper favouring the continuation of the UPCC. The fact that the other nine industry participants that responded to the February Discussion Paper opposed the continuation of the UPCC is hardly surprising given that eight of them are access seekers who would derive a substantial commercial benefit from this outcome. In Telstra's view, it is incumbent on the Commission to consider all arguments on their merits, rather than being swayed by the number of industry participants advocating a particular outcome.

42 Telstra believes that before making any decision regarding the future of the UPCC, and in particular a decision that it should be phased out, the Commission should provide its views on the primary arguments made by Telstra. If it disagrees with Telstra's arguments, the Commission should set out the reasons why it does so. In particular, Telstra requests the Commission to provide its views on at least three of Telstra's main arguments, which the Commission appears to have ignored in the Draft Determination.

43 First, Telstra argues that the CAN infrastructure is used to supply the PSTN OTA service, just as the IEN infrastructure is used to supply the PSTN OTA service. Given that access seekers use both the CAN and the IEN, contributions from access seekers toward CAN costs should not be seen as an artificial mark-up to the PSTN OTA prices, but simply part of the relevant cost pool for the supply of the PSTN OTA service. This is the way the Commission treats IEN costs. If the Commission is to differentiate the treatment of common PSTN costs in the calculation of PSTN OTA prices – that is, treat common IEN

costs differently from common CAN costs – the Commission has not justified why such differential treatment is consistent with the long term interests of end users.

- 44 The Commission uses its argument regarding Telstra’s profitability to justify why a contribution to CAN costs should not be included in PSTN OTA prices. The Commission argues that because Telstra makes sufficient profits to recover any UPCC, that it would be consistent with the legislative criteria to exclude the UPCC from PSTN OTA prices. If this were correct however, the same argument would hold true for IEN costs. All IEN costs are common to the provision of PSTN OTA and other PSTN and non-PSTN services, just as CAN costs are common to a range of services. If it is appropriate to exclude contributions to CAN costs on the basis that Telstra’s profits are high enough to recover all these costs, it follows that it should be just as appropriate to exclude contributions to IEN costs.
- 45 In Telstra’s view, it is inconsistent for the Commission to argue that all common CAN costs should be recovered from Telstra’s profits, but common IEN costs should not.
- 46 Telstra believes that adopting an inconsistent approach to determining service costs in the CAN and IEN would be economically irrational. The reasons for this are set out in the UPCC Submission (see paragraphs 60 to 66).
- 47 Secondly, Telstra argues that requiring it to recover the full cost of the CAN from its own profits, even though access seekers use and benefit from the CAN, would be inconsistent with incentive based regulation used for regulating retail price and also with the efficient competition and investment criteria in section 152AB(2) of the Act. The Draft Determination fails to address Telstra’s arguments in this regard.
- 48 In particular, Telstra argues that the CPI-X regulation which is currently used to protect consumers from any market power that Telstra may have, is used to create a profit incentive for productivity improvements. As a result, economic profits of firms cannot be assumed to be the result of monopolistic output restriction; rather they come from and are the stimulus to and reward for outperforming the regulatory benchmark. Telstra argues that the Commission’s proposal to impose an ex post tax on profits to recover the full CAN costs would undermine the objective of the incentive based regulation underlying retail price regulation in Australia. The Draft Determination fails to address this issue and its implications for removing the UPCC prior to full rebalancing.

- 49 Thirdly, Telstra argues that it would be inconsistent with the long term interests of end users if the Commission were to require Telstra to fund the full cost of the CAN from its profits, while access seekers that use the CAN and profit from this use make no contribution. Telstra set out these arguments in the UPCC Submission (at paragraphs 87 to 95). However, the Draft Determination fails to address the distorting impacts associated with the imposition of a differential profit tax.
- 50 In Telstra's view, the Commission has not provided any sound economic arguments in support of phasing out the UPCC or removing the UPCC from PSTN OTA prior to full rebalancing. In the circumstances, it would be inappropriate for the Commission to consider such phasing out or removal of the UPCC as an option, or for the Commission to reach any view at this time as to the removal or phasing out of the UPCC. This is particularly so given the Commission's previous confirmation of the inclusion of UPCC in PSTN OTA prices, and the fact that Telstra has relied on this in the formulation of its business plans.

Profitability of the PSTN

- 51 In section 8.3.2 of the Draft Determination, the Commission states that “[A]pparent rates of return from the PSTN are well in excess of Telstra's weighted average cost of capital”. The Commission cites certain (partial) analyses in support of this assertion. For the reasons detailed below, these analyses are not appropriate in the circumstances.
- 52 As discussed in Telstra's response to the February Discussion Paper, Telstra does not see any relevance in this assertion.
- 53 Even if the assertion were correct (which it is not), a critical issue in any economic study of profitability is the existence of an appropriately valued asset base on which to assess the required return commensurate with the relevant (nominal) WACC. Given that the WACC is a concept based on opportunity cost, a market-based asset valuation is required to ensure contemporary opportunity costs are identified (rather than opportunity costs based on historic cost). The Ovum study² referred to by the Commission³ is predominantly based on various accounting measures and compares the estimated return on invested capital with an indicative WACC range. However, it appears that the asset base on which the return on invested capital calculation was based is a book value rather than a market value estimate. Therefore, this is not a robust study of economic

² Ovum, *Telstra Financial and Economic Profit Analysis: A Report to the ACCC*, 31 October 2001.

³ Draft Determination, section 8.3.3, page 40, footnote 84.

profitability. In this regard, as acknowledged by the Commission, the RAF is based on historic asset valuations, rendering it uninformative as to whether Telstra’s returns cover the contemporary opportunity costs of its asset base. It is the case that use of historic asset valuations systematically understate true contemporary opportunity costs and hence overstate measured profitability.

54 In relation to the profitability noted by Macquarie Research Equities,⁴ the comment that “fixed line services provide the bulk of Telstra’s cash flow” is hardly conclusive on the issue of whether the cashflow generated is adequate compared with the asset base employed. A statement about the adequacy of cashflow alone without some comparison against the asset base used to generate the cashflow does not inform the issue of adequate profitability.

55 Telstra therefore submits that the Commission’s assertion regarding its profitability is unsupported, and is contradicted by the figures in Table 2 below. Table 2 details the information used in the calculation of returns, based on Telstra’s RAF Report for the six months ended December 2002, and the application of PIE II model network costs where appropriate. The loss on end user access has been distributed across all calling products not included in the table on the basis of minutes of use reported in Schedule 8 of the RAF for the period.

Table 2: Rate of return analysis

Values in \$m's	Access			Local Calls			STD	IDD	F2M	PSTN OTA	PSTN Total
	Retail	Wholesale	Total	Retail	Wholesale	Total					
For the six month reporting period ending December 2002											
Retail & Wholesale Revenue											
Total Retail Revenue	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Total Wholesale Revenue	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Total Other Revenue	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Total Retail & Wholesale Revenue	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Retail + External Wholesale Costs											
Total Organisation Costs	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Total Product and Customer Costs	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Total Retail & External Wholesale Costs			“c-i-c”			“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Gross Retail & External Wholesale Profit/Loss			“c-i-c”			“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Retail Cost of Capital			“c-i-c”			“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”	“c-i-c”
Mobiles Internal Wholesale Costs								“c-i-c”			“c-i-c”

⁴ Draft Determination, section 8.3.3, page 40, footnote 86.

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Retail & External Wholesale Capital Adjusted Profit/Loss			"c-i-c"			"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"
Network Costs from PIE II			"c-i-c"			"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"
Retail & External Wholesale Capital Adjusted Profit/Loss			"c-i-c"			"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"
Allocation of UPCC						"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"
Profit adj for UPCC			"c-i-c"			"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"	"c-i-c"

56 The above figures have been determined on the basis of the following methodology:

- using data from the RAF outcomes for the six months ending 31 December 2002;
- defining the PSTN as being the products 'End User Access', 'Local Calls', STD, IDD, F2M and PSTN OTA;
- replacing RAF Internal Wholesale costs and the network costs for PSTN OTA with equivalent PIE II model outputs;
- adding Mobile infrastructure costs from the 'Internal Wholesale Fixed to Mobile Product'; and
- distributing any UPCC across all calling products.

57 An analysis of Table 2 shows that Telstra does not make economic profits on its PSTN products as it fails to generate a return that recovers its cost of capital. Telstra's estimate of the economic loss made on PSTN products is "c-i-c" for the six months ended December 2002 as indicated in Table 2.

58 In short, Table 2 shows that the PSTN may not be profitable, as the Commission appears to assume.

59 Even if the PSTN were earning economic profits, it does not follow that Telstra should fund the entire cost of the CAN from these profits when access seekers use the CAN and, according to their financial results, make healthy profits. For example, according to the SingTel Group annual report for the quarter and year ended 31 March 2003, it has been a breakthrough year for Optus with a net profit of A\$28 million (A\$338 with the exceptional tax gain) for the year. The report further states that revenue for the year increased by 15% (more than three times the market) and that margins were 24.3%,

almost 5 percentage points higher than the previous year⁵. Similarly, Primus Australia reported a record first quarter net profit from its operations of A\$10.7 million, up 100% from A\$5.4 million in the first quarter 2002⁶. Telecom New Zealand also reports continued improvement from its Australian operation, AAPT. Telecom New Zealand reported that AAPT's earnings before interest, taxation, depreciation and amortisation ("EBITDA") for the 2002 year were up \$56 million or 43.8%⁷.

60 On this basis, Telstra does not believe it is reasonable to propose that it should fund the full cost of the CAN, while access seekers that use Telstra's CAN to generate significant profits, make no contribution to these costs.

Build/Buy Stimulus

61 Telstra has not claimed that it would abandon the entire PSTN as a result of one PSTN service being unprofitable (cf section 8.3.2). Rather, it is Telstra's view that the profitability of PSTN services is irrelevant to determining whether or not a UPCC should be included in the price for PSTN OTA or LCS. As discussed above, it is Telstra's view that the UPCC is simply a contribution to the common costs associated with the provision of PSTN OTA and LCS. Just as the Commission (and regulators around the world) considers it reasonable for access seekers to make a contribution to common IEN costs, Telstra considers that it is appropriate and consistent for access seekers to make a contribution to common CAN costs.

62 It is also Telstra's view that requiring Telstra to bear the full cost of the CAN is unreasonable, given that access seekers appear to be making significant profits from PSTN services. In this regard, the Commission has not explained why it believes that it is reasonable for Telstra's profits to be taxed to recover CAN costs, while those of access seekers are not.

63 In terms of build/buy decisions for access seekers (section 8.3.2), it appears obvious that if access seekers are permitted to use Telstra's CAN without charge, they will have no incentive to deploy their own CAN infrastructure, irrespective of whether or not they are more efficient than Telstra. This outcome is clearly contrary to the objectives of encouraging investment in infrastructure specified by section 152AB(2) of the Act.

⁵ See http://www.optus.com.au/Vign/ViewMgmt/display/0,2627,1031_32591-3_31346--View_303,00.html

⁶ See http://www.primus.com.au/news/articles/news_05-05-03.htm

⁷ See 2002 Telecom New Zealand Annual Report, pages 30-39.

- 64 Moreover, Telstra does not understand in what sense the Commission believes that contributions to CAN costs (ie the UPCC) are artificial. The CAN is part of the PSTN, just as the IEN is part of the PSTN. Hence, contributions to common CAN costs are no less artificial than contributions to common IEN costs. Both the CAN and IEN are part of the PSTN and access seekers that use the PSTN should make a contribution to the costs of these networks.
- 65 If access seekers were to build their own infrastructure to provide PSTN services, either partially or fully, they would need to incur the costs associated with the CAN, either in the form of network deployment costs or access prices for services such as ULLS or line sharing. In Telstra's view, the PSTN OTA and LCS prices should not be any different and excluding a UPCC from these prices would distort the build/buy decisions faced by access seekers.
- 66 Also in relation to section 8.3.2 of the Draft Determination, in Telstra's view the costs of the CAN are common to all users of the CAN. Customers are connected to the rest of the PSTN via the CAN and benefit not only from their own connection, but the connection of other customers to the CAN. That is, a customer in a low cost area benefits from the connection of a customer in a high cost area, as this connection allows the customer in the low cost area to make and receive calls from the customer in the high cost area. In this sense, CAN costs are common to all customers connected to the rest of the PSTN via the CAN. Further, all PSTN customers benefit from the price-cap on line rental services, as this increases the connectivity of the network and thus provides benefits to all customers connected to the PSTN, regardless of whether they are situated in high cost or low cost areas. It follows that all customers benefiting from the price controls on line rentals, should make a contribution to the costs associated with the UPCC.
- 67 Telstra disputes the Commission's conclusion that large margins on PSTN services implies that Telstra has advantages of incumbency, is able to bundle across all services, and benefits from natural monopoly attributes in downstream production components (section 8.3.4). Telstra refers to its discussion on PSTN profitability as set out in section G of this Submission and also Table 2. Further, nowhere in the Draft Determination is there a comparison of Telstra's profitability across PSTN services compared with the profitability of access seekers. Without such a comparison, Telstra does not understand how the Commission can make such assertions. As discussed above, it would appear that Optus, AAPT and Primus, and certainly their respective parent companies, earn substantial profits.

- 68 Telstra also finds it perplexing that the Commission would exclude local calls and basic access from its assessment of margins for PSTN services. As the Commission itself notes in section 12.1.2 of the Draft Determination, there is cross-subsidisation⁸ between Telstra's local call services from its long distance service. Clearly, this implies that the margin across the relevant market (ie the full bundle of PSTN services) is lower than that on STD, IDD and FTM alone. It also means that if access seekers choose to offer pre-selectable services only and not local calls, they can earn a higher margin than Telstra.
- 69 Telstra does not understand why the Commission believes that the UPCC is not competitively neutral. The UPCC is a contribution to the costs of the CAN. As explained above, the CAN is a necessary network element involved in the provision of the UT Services. Telstra calculates the UPCC by deducting from PSTN CAN costs the maximum contributions that it is able to obtain directly from end users. The remainder, the UPCC, is then allocated equally across all PSTN traffic, whether Telstra's retail traffic or access seeker traffic. The only exception to this is where Telstra limits the allocation of costs to local calls, in accordance with the level of costs that can be recovered under the price controls. In this case, Telstra also limits the amount that is allocated to access seekers' local calls. Therefore, every minute of traffic that uses the PSTN makes the same contribution to the UPCC, regardless of whether it is Telstra or access seeker traffic. Telstra does not understand how this approach could be inconsistent with competitive neutrality.
- 70 In Telstra's view, the Commission's example in section 8.3.4 of the Draft Determination regarding an increase in the UPCC being passed on in retail prices is irrelevant. As the PSTN OTA price is based on cost, the only circumstance where the UPCC would increase would be when unit costs are increased. In this event, Telstra's position would be identical to that of access seekers. Telstra's UPCC would only increase if its costs increased and hence its margins would remain unchanged if these costs were fully reflected in retail prices. Once again, Telstra's position is identical to the position of access seekers. Given that the price of PSTN OTA is based on TSLRIC, Telstra does not understand the relevance of the Commission's argument.
- 71 Telstra also does not understand the Commission's assertion that a higher UPCC would only serve to increase Telstra's profits in the context of determining cost-based access

⁸ The term cross-subsidisation is incorrect given that the majority of PSTN costs are common to a range of different services. The point is that Telstra recovers the cost of PSTN services in a different manner to the way in which the ACCC allocates the cost of PSTN services. This is not cross-subsidisation, it just reflects a different approach to the recovery of common costs.

prices (section 8.5.3). Telstra is not seeking a contribution to CAN costs in excess of the cost of the CAN, and thus the Commission's comments regarding a higher UPCC increasing Telstra's profits are misguided. All Telstra seeks is a contribution from access seekers equal to the contribution that is allocated to each unit of Telstra's traffic. Telstra does not consider this unreasonable or inconsistent with the legitimate business interests criteria.

- 72 The Commission's comments in section 8.5.2 of the Draft Determination regarding the allocation of the UPCC between calls and minutes suggests that it also misunderstands the arguments that Telstra has made on this issue.
- 73 Telstra has provided extensive evidence to the Commission in support of the 100:0 allocation of the UPCC. The Commission provides no assessment of that analysis in its Draft Documentation and no reasons for its brief conclusion that this information has not altered its views.
- 74 Even if the Commission is not persuaded by Telstra's economic evidence and follows its own logic regarding the structure of Telstra's retail prices, the majority of the UPCC would still be allocated to calls not minutes. This is because Telstra's retail revenues are used to recover a range of costs associated with providing PSTN services, not just the UPCC. For example, retail revenues for PSTN services make a contribution to the call conveyance costs of the service, the retail costs of the service and service specific costs such as the cost of mobile termination for fixed-to-mobile services and long-distance transmission for STD services. Hence, the structure of Telstra's retail revenues cannot be used to draw conclusions about the structure of the UPCC alone. In other words, the structure of Telstra's retail revenues reflects the structure of recovery of a range of different cost components, not just the UPCC.
- 75 At the very least, the structure of Telstra's retail revenues should be compared with the structure of the total PSTN OTA price. The structure of Telstra's total PSTN OTA price (i.e. UPCC plus call conveyance) is approximately "c-i-c" over the three years of the Undertakings, that is, "c-i-c" of the PSTN OTA charge is proposed to be recovered through the flagfall charge, while the remaining "c-i-c" is proposed to be recovered through per minute charges. This compares with the structure of Telstra's retail revenue for pre-selectable PSTN services (i.e. STD, IDD and F2M) of "c-i-c". If retail revenues for Telstra's local calls are also included, to the same extent that access seekers use PSTN OTA to provide local call services, then the structure of Telstra's retail revenue is "c-i-c".

When this more appropriate comparison is made, the structure of Telstra's PSTN OTA price is consistent with its structure of retail revenue.

- 76 In Telstra's view, moving the structure of the total PSTN OTA price beyond the "c-i-c" structure of retail revenue for pre-selectable services by loading more of the UPCC onto the per minute charge would be unsustainable. Given that Telstra's "c-i-c" allocation of the UPCC results in a "c-i-c" allocation of the total PSTN OTA charge, Telstra believes that there is no basis for reducing the allocation of the UPCC to flagfall charge. If the Commission were to reduce the allocation of UPCC to flagfall further, the PSTN OTA charge would be inconsistent with the structure of Telstra's retail revenue for pre-selectable services.
- 77 In relation to section 8.6.1, it is Telstra's view that the UPCC should not be eliminated until the AD is eliminated. If the Commission adopts the PIE II model, this has implications for the timeframe in which the UPCC can be eliminated and this fact must be acknowledged. Telstra strongly disagrees with the Commission's assertions that the imposition of the UPCC creates any distortions in terms of competition and investment. In contrast, the removal of the UPCC prior to the elimination of the AD would result in such distortions for the reasons set out in the UPCC submission and in the Detailed Submission.
- H DRAFT MODEL ACCESS PRICES FOR THE PSTN O/T SERVICES (section 9)**
- 78 The Commission states in section 9.2 of the Draft Determination, that *"As discussed in Section 5.1.5, regulatory criteria dictate that PSTN wholesale costs should be recovered over all PSTN EMOU"*.
- 79 First, Telstra notes that there appears to be no section 5.1.5 in the Draft Determination.
- 80 Secondly, Telstra is unable to test or comment constructively on the Commission's preliminary estimate of wholesale costs amounting to 0.002c/EMOU, as the Commission has not provided the input values necessary to perform any such analysis. Telstra will provide its views on the preliminary estimate of wholesale costs when these input values have been supplied.
- 81 Thirdly, the suggestion that costs incurred solely as a result of providing services to access seekers should be recovered across all PSTN EMOU is clearly inconsistent with economic efficiency and hence the legislative criteria. Basic economic theory dictates

that costs which are incremental to a service should be recovered from that service. To do otherwise imposes a cross-subsidy and consequential economic efficiency losses. The Commission appears to suggest that the costs incurred solely as a result of providing service to access seekers should be borne by all PSTN EMOU. This amounts to the proposition that even though wholesale costs are in no way common to the provision of Telstra's Retail PSTN Services, these services should bear a portion of these costs. This proposition is not only completely inconsistent with the principles of economic efficiency, but also with the Commission's own approach to allocating costs elsewhere in its various TSLRIC analyses. In Telstra's view, such a position is therefore completely unsustainable.

82 Telstra is also unable to test or comment constructively on the Commission's draft model access prices for PSTN OTA as set out in Tables 9.1, 9.2, 9.3 and 9.4, as the Commission has not provided the input values necessary to perform such analysis. Telstra will provide its views on the draft model access prices for PSTN OTA when these input values have been supplied.

83 With respect to prices payable for access to PSTN OTA provided by non-dominant carriers, Telstra requests that the Commission confirm, in the interests of industry certainty, that the principles as set out in its "*Revised pricing guidelines for access prices of PSTN terminating and originating access services provided by non-dominant or smaller fixed networks - Pricing Principles Paper*" dated January 2002, are those applicable to non-dominant carriers.

I ULLS - network and non-network costs (section 10)

84 Telstra is unable to test or comment constructively on the Commission's proposed network costs as set out in Table 10.1 of the Draft Determination, as the Commission has not provided the input values necessary to perform any such analysis. Telstra will provide its views on the proposed network costs when these input values have been supplied.

II ULLS-specific costs (section 10.2)

85 In section 10.2 of the Draft Determination, the Commission states that it considers that the costs of IT system development and operational costs should be treated as discrete, once-off expenditure. In the Commission's view, these capital costs represent the efficient costs that Telstra would incur in establishing systems for the provision of the ULLS and should be recovered throughout the course of the assumed project life. The Commission

also claims that the ongoing operational and maintenance costs related to the ULLS connection group, wholesale management and associated indirect costs should be absorbed into the operating and maintenance and indirect cost components of the TSLRIC(+) estimate after the relevant period of the project life. Hence, under this approach the Commission states that a ULLS-specific charge should no longer be applicable after the 2004/05 period.

86 In Telstra's view, these arguments are nonsensical. The capital costs associated with IT systems development are recurring costs, hence the 5 year project life. This means that after 5 years, these assets must be replaced and the costs associated with them recovered over the next project life period. To suggest that IT systems development costs only need to be recovered for a period of 5 years implies that the Commission assumes that the IT systems implemented in July 2000 can be used indefinitely, without any further capital expenditure or maintenance costs being incurred. This is a false assumption and is completely inconsistent with the Commission's approach to capital investments, particularly those related to IT, elsewhere in the determination of access prices.

87 Further, the Commission appears to assume that it would be consistent with the legislative criteria to recover ULLS-specific costs across all lines in the network. This is incorrect as a matter of basic economic theory. ULLS-specific costs are costs incurred because of the obligation imposed on Telstra to provide ULLS to other access seekers. Telstra would not have incurred these costs in the provision of its own lines. The basis of allocative efficiency requires that the price of a service recovers the incremental costs associated with the provision of that service. If ULLS-specific costs are not recovered from ULLS, the price signals for ULLS will become distorted, as will the price and therefore consumption of services that subsidise the ULLS. If access seekers (and ultimately consumers) do not value the ULLS at least as much as the costs incurred in providing the service, economic welfare is ultimately improved if the service is not provided. In other words, resources should only be allocated to the provision of a service if consumers value that service in excess of the costs necessary for its provision. If this basic economic principle is ignored, resources may be allocated to inefficient uses at the expense of community welfare.

88 By allocating ULLS-specific costs across all lines in the network, the Commission would break the link between the cost of providing ULLS and the price of ULLS. This is inconsistent with the legislative criteria to which the Commission is required to have

regard. In Telstra's view, economic efficiency requires that costs incurred as a result of Telstra's statutory obligation to provide ULLS should be recovered from ULLS only.

89 In this regard, Telstra also rejects the Commission's use of the consultants' estimates of underlying ULLS-specific costs made more than two years ago. For the purposes of calculating indicative prices, Telstra submits that the relevant costs are those Telstra has compiled on the basis of actual costs incurred and the experience of operating ULLS for that period of time.

12 Commission's views on ULLS-specific costs (section 10.2.4)

Underlying ULLS-specific costs

90 Telstra considers that a separate WACC must be calculated for application in the ULLS context. This separate WACC captures the different risks associated with the specific assets Telstra had to construct in order to deliver ULLS to access seekers. This affects only the beta used for ULLS, with all other WACC parameters valued the same as for the PSTN (as set out in Annexure K of the Detailed Submission).

Multiple WACCs in ULLS Context

91 The market dynamics for access services created by the existence of ULLS and the mix of assets employed in the supply of ULLS renders a single WACC approach inappropriate in capturing the divergent risk characteristics of the asset types employed. ULLS involves access to parts of the PSTN in respect of which a PSTN-similar WACC would be appropriate. It also involves investment in ULLS-specific, non-network assets for which a separate ULLS-specific WACC is required.

92 Separate WACCs for these different asset categories is readily justified. There is a general lack of interdependencies between the ULLS-specific assets and the relevant PSTN assets. The lack of interdependencies subjects the asset types to different risk exposures and requires separate WACCs to adequately capture these exposures. In this regard:

- (a) there is no capital (or construction) interdependency between the ULLS-specific assets and the ULLS PSTN assets. They do not need to be constructed in a coordinated manner and are dimensioned separately. Similarly, there are no maintenance interdependencies

with the maintenance burden of each asset type unrelated to and independent of the other;

- (b) there are no apparent customer interdependencies as the effective customers of the ULLS-specific assets are a narrow range of access seekers, whereas the range of customers of the PSTN is quite wide;
- (c) there are minimal common strategies between the ULLS-specific assets and the PSTN assets and they are "marketed" in separate ways;
- (d) the asset types are distinct and separate rather than being coordinated assets (such as the CAN and the IEN) which must be constructed and operated in a coordinated manner and continue to have significant supply-side interdependencies, when used for the provision for PSTN services⁹;
- (e) the net cashflow of these two asset types could co-vary differentially with the economic cycle implying different systematic risk, different betas and therefore different WACCs.

93 As there is no listed company that solely provides the ULLS-specific assets and associated services from which empirical guidance may be obtained, Telstra considers that the preferred method is to identify and differentiate ULLS-specific risks relative to those of the PSTN.

94 The directional risk differentiators of the ULLS-specific WACC from the PSTN WACC include the following:

- (a) The costs associated with the ULLS-specific assets are largely fixed¹⁰ and hence would have higher operating leverage compared with the PSTN. Fixed costs accentuate the susceptibility of net cash flows to the economic cycle resulting in a higher beta. On this basis, the beta for the ULLS-specific assets would be higher than that relevant to the PSTN assets, other things being equal;

⁹ Notwithstanding that the availability of the ULLS will alter the supply side interdependency going forward.

¹⁰ There is a higher proportion of fixed costs in the cost of ULLS-specific assets than there is in the PSTN costs.

- (b) ULLS itself is relatively new with uncertain and currently ill-defined¹¹ take-up potential;
- (c) ULLS is likely to be used extensively by providers of DSL services the demands for which are more risky because:
 - (i) the demand projections may not be realised; and
 - (ii) in terms of systematic risk, DSL demand is more likely to co-vary with economic activity than normal PSTN demand (ie greater systematic risk).

95 The above factors indicate that the ULLS-specific assets should have a higher beta (and hence WACC) than the PSTN.

96 Augmenting the unlevered beta to reflect the directional risk factors identified above is necessarily subjective. Nevertheless, an appropriate asset beta for the ULLS-specific assets should be “c-i-c” higher than that for the PSTN. This suggests an asset beta for the ULLS-specific assets of somewhere between “c-i-c” and “c-i-c”.

Implications of ULLS for the PSTN WACC

97 There are significant implications for the PSTN arising from the availability of the ULLS. ULLS creates a dichotomy between traffic flows over that part of the PSTN used in the supply of ULLS (“ULLPSTN”) relative to that part of the PSTN bypassed by ULLS (“NULLPSTN”). There are two aspects to this dichotomy.

98 First, the availability of ULLS may cause reduced switch utilisation and bypass of the NULLPSTN. Therefore, the availability of ULLS threatens over-capacity and potential obsolescence in the NULLPSTN¹². Given the operating leverage of the PSTN¹³ this will increase the susceptibility of the PSTN net cashflow to the economic cycle and therefore the riskiness of the NULLPSTN. This factor suggests a higher asset beta for the PSTN in a post-ULLS environment.

99 Secondly, it is extremely likely that the availability of ULLS will facilitate DSL services over the ULLPSTN (but clearly not over the NULLPSTN). Given that DSL services are likely to be more discretionary in nature (relative to the services available generally over the PSTN, which are more of a necessity in nature) it is highly probable that the

¹¹ In terms of quantities and product mix.

¹² This effect occurs even if there was no change in the traffic flows.

¹³ High fixed costs.

ULLPSTN net cashflow will co-vary with economic activity to a greater extent than the NULLPSTN net cashflow. This suggests a higher unlevered beta for the ULLPSTN than that for the NULLPSTN.

100 Therefore, the WACC used to cost the PSTN will be higher in a post-ULLS environment than in the absence of ULLS (which essentially is how the PSTN WACC has been considered).

101 Nevertheless, Telstra believes that cost (risk) causation considerations suggest that the higher PSTN WACC should only be applied in the ULLS context and not in the broader PSTN context. Since these heightened risks emanate directly from the availability of the ULLS, they should be mapped to the WACC used to cost the PSTN in the ULLS context only (ie effectively the ULLPSTN WACC). Telstra is not suggesting that the resultant higher PSTN WACC be used in the broader PSTN context. If an access seeker required interconnection to the PSTN, this would not generate extra risk, a fact reflected in the price of PSTN OTA. However, if the access seeker wishes to acquire ULLS, heightened risks are generated for both the ULLPSTN (product mix weighted towards xDSL) and for the NULLPSTN (heightened bypass risk).

102 Accordingly, an asset beta towards the high end of the potential range should be used in the ULLS-specific beta. Thus “c-i-c” should be used for the ULLS-specific asset beta. This figure captures the extra risks occasioned for the ULLPSTN by the availability of the ULLS and bypass of the NULLPSTN.

103 As noted above, the other component parameters of the ULLS-specific WACC should be the same as in the PSTN-specific calculation (see Table 3 below).

Application of Pre-tax WACC

104 The costing of the ULLS-specific assets varies from that used in the PSTN context. Basically, the ULLS-specific costing levelises capital costs over the span of the asset lives using a standard levelising formula. These annual post-tax amounts are converted into pre-tax equivalents, allowing for the benefit of dividend imputation, using the tax gross-up formula discussed in section H11 of the Detailed Submission. The time series of pre-tax cashflow (increased by the dividend imputation benefit) and the time series of likely demand volumes are both then discounted to a present value from which the unit price is determined (see the equation in paragraph 8 of Annexure M of the Methodology Submission). The WACC variant used in this process must be pre-tax since the cashflows

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to be discounted are pre-tax. The WACC variant should also be exclusive of imputation since the benefit of imputation is already captured in the cashflow (higher reflecting the imputation offset to corporate tax). If imputation was also directly included in the estimated WACC, its benefit would be double-counted (heightened cashflow and lower WACC). Consequently, Table 3 below also sets out the ULLS-specific WACC estimate on a pre-tax imputation exclusive basis.

105 This approach essentially uses a single WACC (rather than the year by year approach used in the PSTN context) and so only a WACC as at 30 June 2002 has been estimated.

Summary of Recommended Pre-tax Nominal WACCs

106 In summary, the following WACCs as set out in Table 3 should be used.

Table 3: Recommended WACCs

Parameter	PSTN Post-tax vanilla	ULL-Specific Post-tax vanilla	ULLS-specific Pre-tax
Riskfree Rate	“c-i-c”	“c-i-c”	“c-i-c”
Debt Risk Premium	“c-i-c”	“c-i-c”	“c-i-c”
Debt Issuance Costs	“c-i-c”	“c-i-c”	“c-i-c”
Market Risk Premium	“c-i-c”	“c-i-c”	“c-i-c”
Debt Gearing	“c-i-c”	“c-i-c”	“c-i-c”
Asset Beta	“c-i-c”	“c-i-c”	“c-i-c”
Debt Beta	“c-i-c”	“c-i-c”	“c-i-c”
Equity Beta	“c-i-c”	“c-i-c”	“c-i-c”
Imputation factor	“c-i-c”	“c-i-c”	“c-i-c”
Tax rate	“c-i-c”	“c-i-c”	“c-i-c”
Post-tax vanilla WACC included in undertaking	“c-i-c”	“c-i-c”	
Pre-tax nominal WACC included in undertaking			“c-i-c”
Equity issuance	“c-i-c”	“c-i-c”	“c-i-c”

costs			
Post-tax WACC including issuance costs	vanilla after equity	“c-i-c”	“c-i-c”
Pre-tax WACC including issuance costs	nominal after equity		“c-i-c”

Demand estimates for ULLS

- 107 As acknowledged by the Commission in section 10.2.3, forecasting demand for new services involves great uncertainty given the lack of historical demand patterns or trends. Telstra submits that the Commission must now seriously review and re-assess demand estimates for ULLS in light of actual demand trends following the launch of ULLS.
- 108 Telstra refers to the Commission’s revised ULLS demand estimates set out in Table 10.3, section 10.2.4 of the Draft Determination. Telstra submits that these revised estimates of demand have a similar degree of credibility as the estimates made by the Commission’s consultants in 2001. They do not reflect the reality of the experience of ULLS since it was launched.
- 109 Moreover, the Commission has provided no mechanism or rationale as to how ULLS demand supposedly will increase by 203% in 2003/04 and by a further 164% in 2004/05. The estimates assume an unproven linkage between broadband take-up and use of ULLS, and employ the same flawed assumptions as the Commission’s consultants in 2001.

Adjustment mechanism

- 110 Telstra agrees with the Commission’s proposition in section 10.2.4 to the effect that, given the uncertainty surrounding demand estimates for ULLS, it is appropriate to apply an adjustment mechanism to prices at the end of each year to account for differences between estimated and realised demand.
- 111 In this regard, Telstra proposes an adjustment mechanism in the following general terms. The basic methodology underlying the adjustment mechanism is a formula which takes the total number of ULLS SIOs at the commencement of each undertaking year, and then adjusts the prices for the services for that year by a given amount in either direction (ie

price decreases or increases) depending on the extent to which actual demand either exceeds or falls below the Commission's demand forecasts. For every 10% increase or decrease above or below these forecasts, there is a corresponding \$1 decrement or increment to the prices. The adjustments are capped at a 60% deviation from those forecasts.

112 In this regard, a fully detailed adjustment mechanism is set out in Annexure A to this Submission.

113 In section 10.2 of the Draft Determination, the Commission refers to the various assumptions underlying its calculation of ULLS specific costs. Telstra is unable to test or comment constructively on the Commission's calculation of ULLS specific costs as the Commission has not provided the input values necessary to perform any such analysis. Telstra will provide its views on the preliminary estimate of wholesale costs when these input values have been supplied.

J LOCAL CARRIAGE SERVICE (Part II, section 12)

114 Telstra agrees with and endorses the Commission's view, as set out in section 12, that service providers do not compete in the supply of local calls alone but in fact compete for a bundle of services which includes local calls, long distance calls and fixed to mobile calls. Accordingly, as stated in sections M1 and M2 of the Detailed Submission, Telstra submits that the price of LCS should be set based on an efficient cost methodology consistent with the pricing approach used for other PSTN services, namely TSLRIC. The RMRC approach adopted by the Commission is inconsistent with both full cost recovery and the fundamental principle of competitive neutrality. Given that the Commission has now acknowledged that access seekers do not compete in the provision of local calls only, there is no longer any basis upon which to set the price of LCS using the RMRC methodology.

115 Telstra also notes the Commission's claims in section 8.3.1 that there are significant margins on PSTN services and the Commission's conclusion that retail prices remain inefficiently high. Telstra does understand the basis for this claim. In the Draft Determination, the Commission has not provided the information necessary to determine what cost items the Commission included in its imputation test. If the Commission has simply used average costs, then it would be impossible for the Commission to conclude that retail prices are "inefficiently high". Telstra and access seekers may simply recover costs across their full range of services in a different manner to how the ACCC allocates

costs for regulatory costing purposes. This does not imply that the profile of cost recovery chosen by Telstra or access seekers is inefficient. In contrast, it might just reflect the fact that the Commission's chosen cost allocation approach is arbitrary and inconsistent with the way in which carriers actually recover their costs in practice. Without reviewing margins across all services supplied by carriers, Telstra does not believe the Commission's allegations are justified.

116 Telstra makes the following comments in relation to the Commission's adjustments to retail costs as set out in Table 12.4 and summarised in section 12.1.3 of the Draft Determination.

Scaling-up of retail share of organisational and product and customer costs

117 Telstra considers the Commission's scaling up of the retail share of RAF cost categories to increase to average retail cost estimate (and hence lower the LCS price) to be seriously flawed for a number of reasons.

118 First, the rescaling demonstrates an inappropriate disregard for the principles and application of the RAF. The RAF was developed over a period of more than two years and involved extensive industry consultation and expert analysis from the Commission's own consultants, Arthur Andersen. In Telstra's view, the Commission's manipulation of the RAF to obtain particular outcomes is entirely inconsistent with the Commission's views on the RAF, in particular that the RAF:

“... means costs can be clearly allocated to specific services with direct, attributable and unattributable elements separately identified across the retail and wholesale components of a carrier's business. The benefits of this approach are:

- *for the Commission, it will minimise opportunities for cost manipulation and provide a basis for comparing costs across different carriers and carriage service providers and the market;*
- *it will provide regular and audited financial and other information*
...¹⁴

119 Secondly, the Commission's basis for the rescaling appears to be that the allocation between retail and wholesale categories for basic access and local calls should be the same as the average allocations across remaining products. However, the Commission provides no explanation or empirical analysis as to the pattern of allocations expected.

An investigation into the wholesale and retail components of Telstra's range of products would reveal that the proportion of costs allocated to retail and wholesale activities for basic access and local calls is completely consistent with the cost characteristics of these products.

- 120 Based on Telstra's allocation guidelines, the allocation of organisational costs between retail and wholesale is determined by the allocation of other costs between retail and wholesale. Where an organisational cost supports an activity that is wholesale related, those costs will be allocated to the wholesale level in the RAF. If a high proportion of a product's costs are associated with wholesale activities, such as network related activities, a high proportion of organisational costs associated with the product (for example, general administration and information technology costs) will also be related to wholesale. A comparison between the proportion of direct expenses that are wholesale and the proportion of organisational expenses allocated to the wholesale layer confirm this (this information has been provided previously to the Commission). Not surprisingly, basic access and local calls are the most wholesale intensive products of all the PSTN services. This is because they form the underlying building blocks for most other PSTN services and hence a substantially higher proportion of the total costs of these products are wholesale costs.
- 121 Given the reasons outlined above as to why the proportion of wholesale costs allocated to basic access and local calls differs from that of other PSTN products, it is Telstra's view that the scaling applied by the Commission is completely inappropriate for the determination of the LCS price.

USO liability saving

- 122 Telstra understands the Commission's position on the USO issue to be that as a wholesale provider of LCS, Telstra no longer faces the same level of USO obligation that it does as a retail provider of those calls, and consequently the reduction in USO payments should be treated as an avoidable retail cost.
- 123 Telstra rejects the Commission's extension of the "hypothetical wholesaler" principle as far as the USO. The Commission has previously justified setting prices of LCS at RMAC on the basis that this price will enable an access seeker to compete with Telstra at the retail level. However, the Commission's proposed treatment of USO is not relevant to the

¹⁴ Commission, *Regulation Impact Statement for the Telecommunications Industry Regulatory Accounting*

situation that access seekers currently face. This method means that access seekers are given an allowance for a cost that they do not actually incur, and which is not relevant to their ability to compete with Telstra at the retail level. This is explained further below.

124 Regardless of the pricing principles the Commission adopts, Telstra will remain the major contributor to the USO fund, at least in the foreseeable future. This is because Telstra will continue to supply local calls and basic access at the retail level. It is unrealistic to assume otherwise. This position is acknowledged by the Commission in its April 2002 pricing principle paper for LCS in the following terms:

“The Commission also notes that Telstra’s compliance with regulatory obligations such as the Universal Service Obligation and Customer Service Guarantee may make it extremely difficult for Telstra to significantly reduce the costs incurred in providing retail services.”¹⁵

125 Therefore, in the context of the Commission’s RMAC approach, there is no reason to assume that Telstra could avoid its USO liabilities in the market as it currently operates. Accordingly, access seekers will not incur any extra USO costs and will have no actual need to add any extra costs to the price of LCS. Thus, USO costs do not impact on the ability of access seekers to compete with Telstra. Including a proportion of Telstra’s USO liabilities in the calculation of avoidable costs for LCS would simply subsidise the operations of access seekers and make it even more difficult for Telstra to recover costs that it clearly cannot avoid.

Avoidable capital financing costs

126 The Commission appears to argue that Telstra, the wholesale provider of LCS, faces a shorter billing cycle (reduced number of days in billing period and reduced time taken for bills to be paid) than it would as a retail provider, and that a lower level of cash balances would therefore need to be maintained.

127 This argument is based on assumptions that Telstra strongly rejects and which are unsupported. In particular, to arrive at a position where Telstra faces reduced working capital requirements, it must be assumed that access seekers will always make payment within the agreed commercial terms (30 days), while retail customers will not. This is clearly an unreasonable assumption and does not accord with industry experience (for

Framework made under section 151BU of the Trade Practices Act 1974, May 2001, page 5 (emphasis added).

example, recent experiences with OneTel and NewTel, among others). The assumption seems particularly unrealistic when the different incentives for timely payment faced by retail customers and access seekers are taken into account.

- 128 In fact, Telstra's records show that the average of debtor days for access seekers is considerably longer than 30 days. Unless access seekers are willing to agree to the terms of payment assumed by the Commission (which are inconsistent with those set out by the Commission in its draft model non-price terms and conditions determination), Telstra submits that any adjustment to the price of LCS based on these assumptions is unreasonable and unsustainable.
- 129 In addition, there is no evidence that wholesale customers necessarily will have a shorter billing cycle than retail customers. Moreover, the nature of wholesale customers means the payment of bigger, "lumpier" sums to Telstra, rather than the more regular and consistent flows that might be expected from retail customers. If anything, there is arguably a case for a higher level of working capital required by Telstra as a pure wholesale provider of these services.
- 130 Telstra does not accept the Commission's unitisation of estimates of total retail costs to obtain per line and per call estimates, as set out in section 12.1.3 of the Draft Determination. Telstra submits that the most appropriate approach to unitising the avoidable retail costs for calculating the RMAC price, is to divide the avoidable retail costs by the total number of local calls (ie retail plus wholesale). This is because the retail costs that Telstra actually incurs are essentially fixed costs, and do not vary to any material degree as a result of access seekers supplying some of the local calls in the market. For example, billing and customer support activities are largely driven by system costs, which are predominantly fixed in nature because the same systems are necessary irrespective of whether Telstra provides all or some retail local calls in the market.
- 131 Similarly, marketing activities relate to the entire retail market, and the costs associated with the marketing of local calls do not change if Telstra loses retail market share for local calls. On the contrary, as Telstra's share of the local call retail market declines, marketing costs are likely to increase in order to minimise competitive losses. If the purpose of an avoidable cost methodology is to estimate the costs with which an efficient retail provider should be able to compete, the appropriate basis for unitising the avoidable retail costs

¹⁵ Commission, *Local Carriage Service pricing principles and indicative prices, Final Report, Revised*, April 2002, page 21.

(which represent the costs associated with the supply of all local calls in the market) is the total volume of these calls.

- 132 This is different from the approach used by the Commission to determine the local call and basic access discounts. The Commission appears to argue that retail local calls should be used to unitise retail costs if there are constant returns to scale, while total local calls should be used to unitise retail costs if all retail costs are fixed. The error in this proposition is exposed by consideration of the following examples.
- 133 Assume Telstra has 100% of the retail market for 1,000 local calls and that there are \$100 of avoidable retail costs associated with these calls. In this case, the correct denominator is 1,000 and the correct per call discount is 10¢. Then assume that Telstra retails only 500 calls, while providing the remaining 500 through wholesale channels. Telstra either avoids:
- (a) \$50 of retail costs (ie constant returns to scale); or
 - (b) \$0 of retail costs (all retail costs fixed).
- 134 If (a) is correct, the denominator would be retail local calls and the discount would be \$50/500 or 10¢/call. However, if (b) is correct, the denominator would be “total local calls”, and the discount would be \$100/1000 or 10¢/call. The approach adopted by the Commission appears to be that Telstra's retail costs are not completely fixed and that it could not be certain about constant returns to scale. Therefore, it has decided to use a denominator half-way between retail and total local calls:

$$\text{local call denominator} = (\text{retail local calls} + \text{total local calls})/2$$

where total local calls is retail local calls + wholesale local calls.

- 135 Telstra submits that the Commission has no basis for this assumption as the retail costs are largely fixed for the reasons set out above. Accordingly, the most appropriate basis is to unitise the avoidable costs using the total local call base.
- 136 Therefore, for the reasons outlined above, Telstra maintains that the effective price of LCS which it has recalculated (as set out in section M2 of the Detailed Submission) is the appropriate rate if LCS charges are to be determined using the RMRC methodology.

J2 Role of the LCS as an access service (section 12.2.3)

The LCO issue

- 137 An increasingly important issue for Telstra, and one that is directly relevant to the model price terms and conditions for the LCS, is the use of LCO by access seekers.
- 138 The use of LCO by access seekers is inconsistent with pricing principles applied in relation to the UT Services and is inconsistent with equitable recovery of efficient costs.
- 139 LCS involves access seekers purchasing end-to-end local calls from Telstra and reselling them to consumers. LCO arose as a method for providing local calls due to a technical loop-hole in the pre-selection mechanism and the Commission's differential pricing of LCS and PSTN OTA.
- 140 LCO involves access seekers procuring customers to prefix the dialling of local calls with the access seeker's specific long distance over-ride code (often through the installation of "auto diallers" in the customer's PABX). This leads to them being charged as if LCO were PSTN OTA. Access seekers also use international special service codes (including 001X and 009X) and VPN access codes (including 188X codes) to achieve the same outcome. The dialling of an over-ride code has the effect of routing the call to a POI between the access seeker and access provider, as if the call were a national long distance or international call, although it is not. However, rather than being conveyed across the access seeker's long distance network (ie to another state or country), the call is then immediately handed back to the access provider for termination in the same standard zone as it originated.
- 141 Over-ride codes were never intended to be used by consumers or access seekers for the provision of local calls. Rather, over-ride codes were implemented to allow consumers to select a provider other than their preselected provider, for the provision of STD, IDD and F2M services on a call-by-call basis. The fact that a bar was never imposed by Telstra to prevent consumers and access seekers using over-ride codes to supply local calls, coupled with the Commission's differential pricing of PSTN OTA and LCS, has resulted in the use of LCO by access seekers for the provision of local call services.
- 142 Specifically, the difference in price between LCO and LCS has created an arbitrage opportunity that access seekers are taking up and which is likely to be compounded if the differential between LCO and LCS prices increase further over time. As with prices for PSTN OTA, LCO is both timed and geographically deaveraged, while the LCS price is untimed and geographically averaged. Hence, access seekers can purchase wholesale

local calls from Telstra using either LCO or LCS depending on the duration of calls and the geographic area.

Indicative prices should relate to service descriptions of the UT Services

- 143 Telstra submits that it is imperative that the Commission ensures that its model price terms and conditions represent indicative pricing for the UT Services. To do this, the Commission must clarify that the indicative prices are predicated on the assumption that access seekers will acquire the UT Services as set out in their respective service descriptions. Only then will the integrity of LCS pricing principles be maintained. Access seekers should not be allowed to arbitrage and undermine those pricing principles by seeking to obtain the charges for PSTN OTA in circumstances where the service acquired does not properly fall within what is properly contemplated by that service description, in order to avoid paying the LCS price.

Local calls using PSTN OTA fall within the LCS service description

- 144 In this regard, Telstra submits that the Commission's final determination on model price terms and conditions should make it clear that the indicative pricing for LCS applies to *all* end-to-end local calls supplied by the access provider to the access seeker, irrespective of whether these calls transit a POI. As set out below, this approach is supported by the Commission's service descriptions for both LCS and PSTN OTA.
- 145 Telstra submits that the carriage of local calls where the call temporarily departs Telstra's network and transmits to the access seeker's network because the end-user dials the access seeker's over-ride code, falls within the meaning of LCS as defined in the ACCC Register of Declared Services ("**Register**"). However, the carriage of local calls dialled with an over-ride code falls outside the Commission's service description for PSTN OTA.
- 146 The Register defines LCS as:
- "a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone."*
- 147 This definition is technology-neutral. Further, consistent with industry practice, it does not limit LCS to the carriage of calls over a single carrier's network. For example, if a service provider provides an end-to-end local call to its end user customer by resupplying a call from an "A party" directly connected to Telstra's network to a 'B party' directly

connected to another carrier's network, the LCS call travels over two carriers' networks. However, the access seeker still acquires from the access provider and supplies to its customer, a telephone call "*from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone*". Therefore, the service provided by an access provider to the access seeker remains LCS, despite the fact that the telephone call has travelled via two different networks.

148 When an over-ride code is dialled, the telephone call originates from the access provider's network but then temporarily departs that carrier's network and is carried briefly on the network of the carrier whose over-ride code is dialled (the access seeker), before being handed back to the access provider (Telstra) for termination (as illustrated in Figure 2 below). That is, the call traverses both Telstra's network and the access seeker's network. By analogy to the example in the above paragraph, the access provider continues to provide end-to-end carriage of the local call. Despite the temporary departure of the telephone call from Telstra's network, a local call made via an over-ride code continues to be an LCS call.

149 Moreover, Telstra submits that local calls made via over-ride codes do not fall within the service description for PSTN OTA. The service description for domestic PSTN originating access in the Register provides that:

"1.3.1 The service is provided on a call that is made with:

- *pre-selection; or*
- *a AS specific code including Special Services codes and number ranges (with some exceptions) as per table POASD7; or*
- *a long distance, international or shared operator codes dialled with an over-ride/ access code in accordance with the Australian Numbering Plan."*

150 A similar description applies to domestic PSTN terminating access.

151 Telstra submits that local calls made via over-ride codes clearly fall outside the definition of PSTN OTA. This is because:

- (a) a local call made via an over-ride code is *not* a call that is made with "pre-selection" (as pre-selection does not apply to local calls);

- (b) over-ride codes dialled to access local (and long distance) calls do *not* fall within table POASD7, which deals with international special services and shared services codes; and
- (c) as domestic PSTN originating access only applies to long distance, international or shared services codes, it does *not* apply to local calls.

152 Further, Telstra contends it was clearly never intended that Telstra have an obligation to provide over-ride capability in respect of local calls. Although the drafting in the *Telecommunications (Provision of Pre-selection of a Standard Telephone Service) Determination 1998* (“**the Determination**”) is somewhat ambiguous in that it does not expressly exclude local calls, an examination of the ACIF Industry Code on “*Pre-Selection - Single Basket / Multi Service Deliverer*” (“**the Code**”)¹⁶, which was registered by the ACA and the Explanatory Statement accompanying the Determination, clearly shows that the ACA did not intend to require carriers or carriage service providers to provide pre-selection over-ride in relation to local calls.

153 The Explanatory Statement to the Determination unequivocally states under the heading “Background”, that:

“The Determination only applies to a single group or “basket” of calls which are referred to in the Determination as “pre-selectable services”.”

154 In relation to sections 5 and 6 of the Determination, which are the operative provisions, the Explanatory Statement provides that:

“[These] section[s] ... require carriage service providers to provide pre-selection and use over over-ride dial codes in relation to the pre-selectable services.”

155 The term “pre-selectable services” is defined in the Determination as meaning:

“...a call using a standard telephone service to:

- (a) *a geographic number or local number that is **not a local call***

...”

¹⁶ ACIF C515: April 2003 Industry Code on Pre-selection is intended to replace the previous ACIF C515 June 1999 Code. However, the new Code has not yet been registered. The relevant provisions of the 1999 Code are retained in the April 2003 Code.

156 The Code also clearly excludes local calls in its definition of “pre-selectable services”. It provides that:

“Pre-selectable services means a call from a Standard Telephone Service (other than a call that originates on a public mobile telecommunications service) to:

*(a) a geographic number or local number that is **not a local call**;*

...

*but for the avoidance of doubt does **not include** for example:*

...

(g) Local Calls;

...”.

The impact of LCO

157 LCO generates significant inefficiencies. These inefficiencies occur both because the arbitrage is inconsistent with the equitable recovery of efficient costs and also because the network routing of LCO puts significantly more burden on Telstra’s PSTN infrastructure, and the infrastructure of access seekers, compared with LCS.

Equitable cost recovery and the effective price of LCS

158 In the Draft Determination, the Commission’s LCS price for 2002-03 and 2003-04 is between 12.81 and 13.61 cents per call (including the discount for basic access). Thus, in the Commission’s view, Telstra should be able to secure between 12.81 and 13.61 cents per local call from access seekers for provision of LCS.

159 However, the Commission’s LCS price fails to take into account the use of LCO by access seekers and the consequent impact for the effective contribution that Telstra can secure toward the wholesale costs of local calls.

160 LCO now accounts for a significant proportion of total wholesale local calls. This means that the effective revenue that Telstra secures from wholesale local calls is substantially lower than the range of 12.81 to 13.61 cents per call advanced by the Commission.

161 As noted by the Commission, the rates in its Draft Determination are already less than TSLRIC++, and hence this further reduction in revenues created by the arbitrage

opportunity between LCS and LCO exacerbates the issue of cost recovery in an equitable manner.

162 This outcome is unreasonable and unjustifiable, and one which also fails to take sufficient account of the legitimate business interests of the access provider.

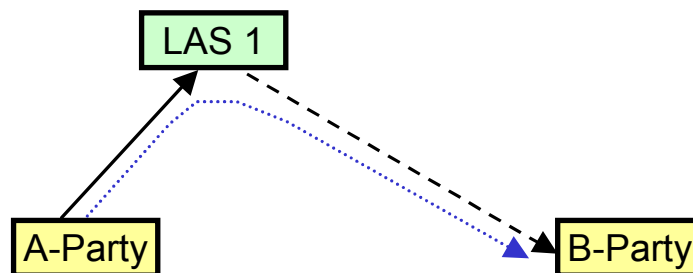
163 As the use of LCO is also increasing, in the absence of a solution to address the arbitrage Telstra will be required to fund an increasing share of the costs associated with local calls supplied by access seekers.

Network efficiency compromised by LCO

164 LCO gives rise to inefficiencies in the use of Telstra’s network.

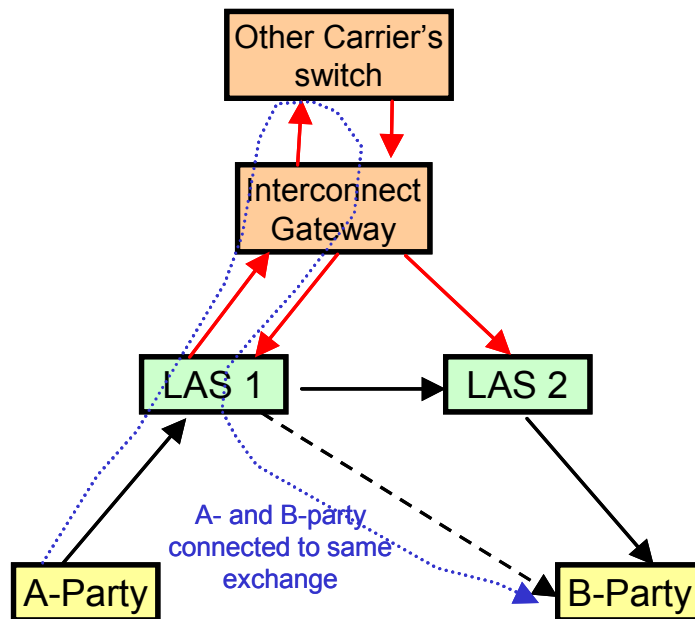
165 The network inefficiency can be demonstrated most readily through an example. When a local call is made between parties connected to the same local switch (“LAS”), it can be carried much more efficiently via LCS than via LCO. Figure 1 below illustrates the routing of an LCS call (carried end-to-end by Telstra) between two parties connected to the same local switch. The call is simply routed from the A-party to the B-party via a single local switch.

Figure 1: General LCS routing



166 In contrast, an LCO call between the same parties would utilise substantially more network resources. The call will be routed from the A-party to an interconnect gateway, to the access seeker’s switch, back down to the local switch before being terminated to the B-party. Not only does this routing use more of Telstra’s network resources, but it also requires access seekers to have the capacity to accommodate LCO traffic, which it simply hands back to the Telstra network. The inefficiencies of the LCO routing are depicted in Figure 2 below.

Figure 2: General LCO routing



167 The arbitrage opportunity provided by the differential pricing between LCS and PSTN
 168 OTA is large enough to provide access seekers with the incentive to invest in additional
 switch port capacity in order to accommodate LCO traffic, even though this routing is
 inefficient and unnecessary. It also artificially distorts investment decision away from
 more efficient means of providing local services, including ULLS, LCS and direct
 connections. Hence, the arbitrage opportunity is clearly inconsistent with the efficient
 investment and use of network infrastructure criteria in the legislation.

Dealing with the problem

168 For all of the reasons outlined above, LCO is a problem which must be addressed.

169 Telstra submits that the Commission should address the LCO problem by confirming that
 local calls which are prefixed by an override code are within the LCS service description,

and ought to be priced as such. This would remove the problems raised by LCO, whilst allowing access seekers to use LCO should they wish to do so.

170 An alternative solution to address the arbitrage between LCO and LCS lies in eliminating the price discrepancy between the two services. While there are a number of ways that this can be achieved in practice, the options amount to:

- changing the LCS price to a timed, geographically de-averaged rate similar to PSTN OTA; or
- according LCO an untimed, geographically averaged rate to match LCS.

171 The benefits and difficulties associated with each approach are discussed below.

Changing LCS price to match PSTN OTA

172 This option involves charging LCS on a timed, geographically de-averaged basis. Effectively, LCS would be charged at identical rates to PSTN OTA to eliminate LCO arbitrage. It would be necessary for the LCS price to *mirror* the PSTN OTA charge (or specifically the sum of the relevant originating and terminating charges). It would not be sufficient to implement a timed geographically averaged charge for LCS because LCO would still be more attractive than LCS in low cost areas.

173 Therefore, one way to eliminate the use of LCO instead of LCS is to charge LCS on exactly the same basis as LCO, that is, at geographically deaveraged, timed rates.

174 Importantly, this issue does not depend on whether the PSTN OTA rate includes a contribution to the UPCC.

175 The benefit of changing the LCS rate to match the PSTN OTA rate is that it would remove the price differential. Access seekers purchasing wholesale local calls in low cost areas would be just as well off using LCS, as it would be priced at the same rate as LCO. Access seekers would be indifferent between LCS and LCO and hence the inefficiencies associated with inefficient LCO network use could be addressed by providing all local calls using LCS. This approach would also allow Telstra to recover the costs allocated to local calls from access seekers and would put Telstra and access seekers on an equitable basis in terms of cost recovery.

- 176 The difficulty with this approach is that it would make LCS calls in high cost areas very expensive for access seekers – well above the retail price-cap. For example, for a local call of 12 minutes in duration, access seekers would end up paying Telstra 20.3 cents per local call in provincial areas and 93.6 cents per local call in rural areas. Importantly, these very high costs in rural areas for local calls are not a temporary result created by the UPCC. Even if the UPCC were excluded from the PSTN OTA charge, a local call of 12 minutes duration would cost an access seeker 87.0 cents in rural areas.
- 177 Given the very high costs of call conveyance in rural areas, Telstra does not believe that the Commission would allow LCS prices to be charged on a timed, geographically deaveraged basis. Further, because a timed geographically averaged pricing structure would not address the arbitrage opportunity, Telstra does not believe that this solution would be workable in practice.

According LCO an untimed, geographically averaged rate to match LCS

- 178 This option involves charging LCO calls on the same basis as LCS calls, that is, charging LCO on an untimed, geographically averaged basis. Based on the Draft Determination this would involve charging LCO calls at the LCS rate between 12.8 and 13.6 cents per call.
- 179 The benefits of this approach are that it reflects the Commission’s service descriptions for LCS and PSTN OTA and it removes arbitrage. Hence, it would remove the inefficient use of the PSTN to route local calls and would allow Telstra to at least recover the RMAC revenue from all wholesale local calls.
- 180 This approach would also accommodate the Commission’s suggestion of moving from RMAC to TSLRIC. That is, if the Commission determined that LCS should be priced on a geographically averaged, timed TSLRIC rate in the future, then LCO would also be moved to a timed, geographically averaged TSLRIC rate.
- 181 Given that this approach is consistent with the service descriptions, addresses arbitrage, allows Telstra to recover at least the RMAC of wholesale local calls, encourages the efficient use of Telstra’s network and efficient investment by access seekers and provides for a smooth transition to TSLRIC-based pricing for both LCS and LCO, this is Telstra’s preferred approach in relation to the alternative solution referred to in paragraph 170. This approach would also address the problem raised by the Commission regarding LCO extending the use of RMAC by increasing the TSLRIC of local calls. By pricing all local

calls on a consistent basis, the transition from RMAC to TSLRIC pricing would be accelerated.

- 182 Finally, Telstra would obviously be willing to implement the changes according to an agreed migration plan to smooth the introduction of consistent pricing for wholesale local calls.

Other options

183 There are other options open to the Commission to address the arbitrage between LCS and LCO. These options are unlikely to be acceptable in the short to medium term.

184 One option is to revoke the LCS declaration in areas beyond the CBDs. While such an approach would be consistent with the stated intentions of the Commission's initial declaration decision, ie for LCS to act as a transitional service, and would close the arbitrage opportunity, Telstra does not believe that this would be a satisfactory short-term solution. Given the time involved in obtaining the exemption from LCS in CBD areas and the high costs associated with providing local calls if access seekers were required to provide local calls at the timed, geographically deaveraged PSTN OTA rate, Telstra does not believe that this is a practical solution for the same reasons discussed above.

Dated: 31 July 2003

ANNEXURE A TO TELSTRA’S SUBMISSION ON THE DRAFT DETERMINATION FOR MODEL PRICE TERMS AND CONDITIONS OF THE PSTN, ULLS AND LCS SERVICES

Proposed ULLS Adjustment mechanism

Telstra’s proposed adjustment mechanism in relation to ULLS for the year 2004/05 (a similar adjustment to apply for the year 2005/06) is in the terms set out below. References to [X] are to the Commission’s relevant demand forecasts, as set out column 1 of Table B and Table C.

- (a) Within [] days after 1 July 2004, Telstra will calculate and notify the Access Seeker of the total number of Telstra Unconditioned Local Loop Services (to avoid doubt, including Telstra Unconditioned Local Loop Services supplied to persons other than the Access Seeker) that had been connected as at 30 June 2004 (“**Connected Services Total**”).
- (b) If the Connected Services Total exceeds [X] then, with retrospective effect from 1 July 2004, the charges in Table A will be decreased in accordance with Table B where the number ranges in the first column of Table B refer to the Connected Services Total and the corresponding charge decrements in the second column refer to the dollar amounts to be deducted from the charges in Table A.
- (c) If the Connected Services Total is less than [X] then, with retrospective effect from 1 July 2004, the charges in Table A will be increased in accordance with Table C where the number ranges in the first column of Table C refer to the Connected Services Total and the corresponding charge increments in the second column refer to the dollar amounts to be added to the charges in Table A.

Table A - Monthly Charges

Monthly Charge Telstra Unconditioned Local Loop	Band 1	Band 2	Band 3	Band 4
	\$[] per month	\$[] per month	\$[] per month	\$[] per month

Table B - Charge Decrements

Connected Services Total at 30 June 2004	Charge Decrement (in \$)
58,301 - 62,799	1
63,800 - 69,099	2
69,100 - 74,399	3
74,400 - 79,699	4
79,700 - 84,500	5

Table C - Charge increments

Connected Services Total at 30 June 2004	Charge Increment (in \$)
42,401 - 47,699	1
37,101 - 42,400	2
31,501 - 37,100	3
26,501 - 31,500	4
21,200 - 26,500	5