



INTERNATIONAL

FINAL REPORT

Prepared For:

Telstra

Expert Report on Recovery of ULLS-Specific Costs (Public Version)

Prepared By:

Henry Ergas

CRA International

Level 1, 29 Jardine Street

Kingston ACT 2604, Australia

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1. INTRODUCTION

1. It has been the ACCC's practice to date to allow recovery of ULLS-specific costs from ULLS lines. However the ACCC is now canvassing the possibility of the recovery of Telstra's ULLS-specific costs through prices of services other than ULLS. Specifically, the ACCC is considering a per line charge on existing ULLS and on:
 - all lines once used by ULLS access seekers in the past; or
 - all lines used by Telstra to supply retail and wholesale DSL; or
 - all Telstra's DSL capable lines not presently leased as ULLS.¹
2. In the second case it is understood that the per line charge would involve recovery of integrated ULLS and DSL systems costs from the relevant lines. This is based on the ACCC's view that ULLS-specific costs should, over time, become part of the system costs common to the provision of DSL services.²
3. In the last case, it appears the ULLS-specific costs would be spread over all DSL capable lines. This reflects the ACCC's view that the ULLS is an arrangement that potentially allows all lines to move between competitors and Telstra. It considers that this benefits all end-users, and so the costs of the ULLS-specific costs should be borne by all lines.³
4. I understand that the ULLS-specific costs are caused by ULLS alone. As a result, economic efficiency and the statutory criteria require that they be recovered from only ULLS lines.

1 ACCC, 2005, Telstra's Undertakings for the Unconditioned Local Loop Service, Discussion Paper, January, p. 21.

2 Ibid. p. 19, 21.

3 ACCC, 2005, Op. cit. pp. 19-21.

2. EXPERTISE

5. I have since the end of 2004 been Vice President, Head of CRA International Australia and CRA International's Asia-Pacific Competition practice. Between 1998 and 2004 I was the Managing Director of the Network Economics Consulting Group ("**NECG**"). In these roles I have provided economic advice to government bodies and major corporations in Australia, New Zealand and the European Union in a wide range of industries, including telecommunications, electricity, aviation, surface transport and financial services. A significant proportion of this work has involved research on issues related to the estimation of service costs and examination of issues related to regulation of the prices which firms can charge (see Appendix A).
6. In March 2004, I was appointed as a member of the Australian Centre of Regulatory Economics (ACORE) Advisory Group. The Advisory Group advises the Board on matters pertaining to regulatory activities. I am also Adjunct Professor of Economics at the National University of Singapore.
7. In March 2005 I was appointed to a taskforce by the Prime Minister to identify bottlenecks in the operation of Australia's infrastructure that may impede Australian exports.
8. I have provided expert testimony before the Australian Competition Tribunal ("**ACT**"), Federal and Supreme Courts in relation to a number of Trade Practices and competition matters. Key recent examples of this testimony include:
 - The AGL Loy Yang merger case before the Federal Court;
 - The Qantas/Air New Zealand appeal to the ACT on the decision by the ACCC to reject a proposed strategic alliance;
 - An appeal by Qantas to the ACT in relation to a decision by the NCC not to declare Sydney Airport;
 - The Baxter Healthcare bundling case before the Federal Court;
 - The Duke Energy access arrangements case before the ACT;
 - The Epic gas pipelines access pricing case before the WA Supreme Court (further details are provided in Appendix A).

9. Between 1987 and 2003, I assisted Governments in Australia and overseas on matters related to competition policy. In 1999, I chaired the Australian Intellectual Property and Competition Review Committee set up by the Federal Government. This committee reviewed Australia's intellectual property laws as they relate to competition policy. In July 2001, I was appointed by the Attorney General of New Zealand as a lay member assisting the New Zealand High Court in cases involving appeals from decisions of the Commerce Commission and in other matters under the Commerce Act 1986 (NZ). Between 1993 and 1997 I was an advisor to the Australian Trade Practices Commission (now the ACCC).
10. Between 1987 and 1995 I held teaching positions at a number of leading institutions, including Visiting Professor at the Kennedy School of Government at Harvard University (2 years) a Professor at the Centre for Research in Network Economics and Communications at the University of Auckland (2 years) and a Professor in the Graduate School of Management at Monash University (3 years). I have also taught at the Ecole Nationale de la Statistique et de l'Administration Economique in Paris.
11. The final area of expertise on which I have relied upon in the preparation of this report is in the area of network economics. Network economics encompasses the study of costs, investment, financing, competition and regulatory policy, as they arise in network industries. A network industry is any industry that depends on a physical or virtual network, including electricity, telecommunications and transport of all types. An understanding of network economics in general and regulated telecommunications industries in particular, has been useful in preparing this report. In that regard, my appointment as the inaugural BellSouth Visiting Professor of Network Economics at the Centre for Research in Network Economics and Communications at the University of Auckland provided me with an opportunity to review and apply the latest scholarly research related to the economics of networks, including pricing issues.
12. I have also completed numerous consultancy assignments for telecommunications companies in Australia, Italy, New Zealand and Latin America (see Appendix A).

3. ECONOMIC EFFICIENCY AND RECOVERY OF ULLS-SPECIFIC COSTS FROM ULLS LINES

13. It is my understanding that ULLS specific costs are the incremental costs of systems for qualifying and ordering ULLS. That is, these costs are directly attributable to ULLS and are not shared with other wholesale and retail services. They are incurred *in addition* to the costs of systems used for other wholesale and retail services supplied by Telstra, and *are only incurred because Telstra supplies ULLS*.⁴
14. A key principle of economics is that, to achieve full economic efficiency, the prices of goods and services should recover their incremental costs⁵. When prices meet this principle, consumers who act so as to maximise their own well-being make purchases up to the point that their valuation equals the incremental cost of the purchased goods and services. Equally, suppliers undertake costly production processes up to the point that the incremental cost of what they produce equals consumers' valuations of that output. The result is that society's resources are directed to their highest valued use. Where prices diverge from recovering incremental costs, too much or too little of the priced goods or services are produced and consumed, thereby changing production and consumption levels from the optimal level (that is, that which would occur with incremental cost pricing), all benefiting parties notionally could compensate any losers, and still be better off.⁶
15. This theoretical ideal cannot be met for production processes that incur some shared costs that cannot be fully avoided if the service in question were not produced. In these circumstances, if all services were priced at their incremental cost, the firm's total costs would not be recovered and the business would not be sustainable. This is generally the case for telecommunications services, for which network costs are often shared with other services. What remains clear, however, is that economic efficiency considerations dictate that the prices of services should recover *at least* their incremental cost, to avoid providing an incentive to consume services beyond the point at which the price which consumers are willing to pay covers the direct costs of provision of the service.
16. In short, economic efficiency considerations suggest that ULLS-specific costs, which are caused by the production of the ULLS, should be recovered only from ULLS, thereby ensuring ULLS prices reflect the costs of its provision. The prices of other services supplied by Telstra should not include a contribution to costs that are not incurred in their supply.

4 This is explained in Telstra's submission in support of the ULLS monthly charges undertaking dated 13 December 2004, Annexure D, p. 3.

5 An exception to this occurs where there are externalities not captured by (private) incremental costs, but there are no reasons to believe this is an issue in this case.

6 See for example A. Kahn, 1995, *The Economics of Regulation: Principles and Institutions*, Vol. I, pp. 63-70.

17. If Telstra's other wholesale and retail prices were to incorporate the ULLS-specific costs, they would be over-priced relative to their resource cost, while ULLS would be under-priced compared its costs. ULLS access seekers would be provided with an artificial relative price advantage. Competitive pressures would tend to expand ULLS acquired beyond efficient levels, and reduce Telstra's retail output below efficient levels. Moreover, investment incentives facing both Telstra and access seekers would be inefficiently distorted. For example, access seekers could view purchasing ULLS to be superior to building their own network, when this is merely due to the subsidisation of ULLS-specific costs by other services, while Telstra's return on retail (and other wholesale) services, after the tax to recover ULLS-specific costs, would lead it to inefficiently under invest in those services (since Telstra's services compete with retail services supplied on subsidised ULLS).
18. It is also important to recognise that the efficiency-damaging consequences (just outlined) of subsidising ULLS occur by undermining the process where Telstra and access seekers compete in the market on their relative merits. This would enable access seekers not as efficient as Telstra to win market share at Telstra's expense.
19. In summary, all these effects reduce productive, allocative and dynamic efficiency,⁷ while harming Telstra's shareholders merely as a matter of regulatory fiat.
20. The ACCC also appeals to the principles of non-discrimination (equivalence of terms and conditions of supply) and competitive neutrality as reasons to support spreading the ULLS-specific costs over all lines.⁸ However, these arguments support Telstra's position, rather than that of the ACCC. Considerations of equivalence of terms and conditions of supply, and competitive neutrality, are best served by prices that reflect costs. Thus Telstra's supply of DSL services should cover the direct costs of the DSL service, just as broadband services provided by Telstra's competitors using the ULLS should meet the direct costs they incur.
21. The ACCC moots that taking a forward looking TSLRIC approach to costing of Telstra's network could imply that that the totality of Telstra's lines would be available for the ULLS and that the associated carrier interface systems ("**ULLCIS**") would in effect serve all lines and hence their cost should be spread over all lines.⁹ Quite simply, however, the fact that all Telstra's access lines are potentially available for ULLS is irrelevant to efficient recovery of ULLS specific costs. A line which is currently not used for a ULLS service in no way causes the costs in question (and in any case not all of Telstra's lines will one day experience use as ULLS—indeed a large number likely never will).

⁷ These are outlined in ACCC, 1997, *Access Pricing Principles Telecommunications – A Guide*, July, pp. 7-8.

⁸ ACCC, 2005, *Op. cit.* p. 20.

⁹ *Ibid.*

22. The ACCC also canvasses recovering ULLS-specific costs from all lines that currently are or have ever been used to supply ULLS, apparently on the basis that these lines are the lines likely to be supplied as ULLS. But again this is simply wrong. There is no basis for asking a customer to pay for ULLS when they are not making use of ULLS. If at some point an access line is used to supply ULLS, then at this point it would appropriately contribute to ULLS-specific costs. Under either of the above two proposals Telstra would be required to recover some of the ULLS-specific costs from prices of its own lines, higher prices for other services or, where neither of these are possible due to competition in the market, have to bear those costs as a cost to shareholders.

3.1. RECOVERY OF ULLS-SPECIFIC COSTS AND THE STATUTORY CRITERIA

23. The notion that ULLS-specific costs be spread over lines other than existing ULLS lines is contrary to three of the key statutory criteria to which the ACCC must have regard in setting access prices. These three criteria are the long-term interest of end-users (LTIE), the recovery only of direct costs of providing the access service and the promotion of efficient investment.¹⁰ Why this is the case is discussed for each of these criteria in turn below.

LTIE

24. The LTIE is the overriding criterion by which an access price is to be judged as reasonable by the ACCC. In the ACCC's view, this criterion is promoted by factors such as lower prices, higher quality and greater choice. It is inconceivable that the LTIE is served by adding a cost to all users that arises solely from the supply of an access service to the customers of Telstra's competitors.¹¹ This is similar to demanding that a manufacturer, which both wholesales and retails its output, require its retail customers to subsidise the costs the manufacturer incurs in wholesaling to third parties so as to lower its wholesale prices: the manufacturer's retail customers would be penalised and its retail sales would suffer; while its wholesale sales would be artificially expanded and the third parties that bought at wholesale would expand, relative to the manufacturer's retail business, even if they were less efficient. The efficiency losses of such an approach, which necessarily harm the LTIE, are described in detail in the preceding section.

¹⁰ These are outlined in detail in ACCC, 1997, Op. cit.

¹¹ Recovery of ULLS specific costs, and similar costs associated with the provision of other access services, from the access seekers using these services has also been the ACCC's position to date, which is in my view consistent with its broad access pricing principles. See ACCC, 1997, Op. cit.

Direct costs of providing the access service

25. This criterion requires that access prices should be set to recover the direct costs of supplying access. As indicated above, my understanding is that the ULLS-specific costs have been incurred purely for the purpose of providing the ULLS. They are therefore clearly part of the direct costs of providing the access service, and as such should be recovered from that service.

Promotion of efficient investment

26. This criterion requires that access prices be set having regard to the investment efficiencies discussed above. The conclusion of the discussion in that section is that the recovery of ULLS-specific costs from all lines rather than just ULLS lines, would not promote efficient investment by Telstra and access seekers.

Dated: 25 May 2005

Henry Ergas

APPENDIX A: HENRY ERGAS - RECENT EXPERT TESTIMONY AND TELECOMMUNICATIONS EXPERIENCE

27. I have extensive international experience advising government bodies and major corporations in Australia, New Zealand and the European Union. Following is a selection of my recent expert testimony and telecommunications related projects with which I have been involved:
- (a) The successful application by the Australian Gas Light Company, to the Federal Court of Australia, seeking a declaration that its acquisition of electricity generator Loy Yang A would not substantially lessen competition for the purposes of section 50 of the TPA. My expert testimony on behalf of AGL was influential in Justice French's decision, (2003).
 - (b) I provided expert testimony in a successful appeal on behalf of Air New Zealand and Qantas Airways to the ACT in relation to their application to enter into a strategic alliance, (2004).
 - (c) I provided expert testimony on behalf of Qantas Airways in an appeal to the ACT in relation to a decision by the National Competition Commission not to declare Sydney Airport.
 - (d) I provided expert testimony on behalf of Baxter Healthcare before the Federal Court, which was alleged to have engaged in anti-competitive bundling activity, in breach of s 46 of the Trade Practices Act, which prohibits the taking advantage of substantial market power, as well as s 47, which prohibits exclusive dealing that has an anti-competitive effect, likely effect or purpose.
 - (e) I provided expert testimony on behalf of Duke Energy to the ACT, which subsequently ordered that the Eastern Gas Pipeline could operate outside the National Gas Access Code. My testimony was influential in the ACT's conclusion that coverage of the Eastern Gas Pipeline would not promote competition in either upstream or downstream markets to a greater extent than the existing voluntary access offered by Duke under Part IIIA of the Trade Practices Act 1974, (2003).
 - (f) Expert testimony on behalf of Alinta Gas in the Epic Dampier to Bunbury natural gas pipeline proceedings before the WA Supreme Court. The owner (Epic Energy (WA) Nominees Pty Ltd) and operator (Epic Energy (WA) Transmission Pty Ltd) of the pipeline sought, amongst other things, to set aside the June 2001 draft decision of the Independent Gas Pipelines Access Regulator in Western Australia in respect of proposed access arrangements for use of the pipeline by third parties.

- (g) Since the early 1990s, I have advised Telstra and participated in the public debate on a range of regulatory and competition issues. This work includes:
- International Benchmarking of Telstra's Prices for PSTN Originating and Terminating Access Services in support of Telstra's core service undertakings, (2003)
 - Benchmarking and estimating the weighted average cost of capital for major international telecommunications' carriers to support Telstra's appeal of the ACCC's decisions on the price of access to the Telstra public switched telephone network, (2001).
 - An analysis of the costs and benefits of increasing the customer service guarantees (CSGs) and the free provision of directory assistance services by Telstra, (2001).
 - A number of studies of the costs and benefits associated with different access pricing arrangements as they relate to declared services in Australia, including into PSTN originating and terminating access, the unconditioned local loop service, GSM termination services, local and mobile number portability, data services such as ISDN and DDAS and the local carriage service, (1998–2002).
- (h) Outlining the pricing principles that should be resident in a pricing model and reviewing a pricing model for internet peering in light of these principles, (2002).
- (i) Preparing submissions for Telecom Italia on the new European telecommunications regime, and advising that corporation on an ongoing basis on a wide range of regulatory and competition issues. This includes provision of expert advice and a report on behalf of Telecom Italia during 2004 in relation to the Autorita' Garante della Concorrenza e del Mercato's (AGCM) recent investigation into whether Telecom Italia's pricing at both the wholesale and retail levels amounted to an abuse of dominant position under Article 3 of the Italian general antitrust laws. This report formed the basis of Telecom Italia's recent successful appeal of the AGCM's decision to the Administrative Court (TAR).
- (j) Advising a major US telecommunications corporation on regulatory issues related to its mobile telecommunications operations in Latin America, (2002).
- (k) Analysis for Telecom NZ of the costs and benefits of the Australian telecommunications regulatory regime and an analysis of the costs and benefits of regulating a range of communications services in New Zealand, (2000).