

TELSTRA CORPORATION LIMITED

Telstra's Ordinary Access Undertaking for the Unconditioned Local Loop Service:

Response to the ACCC's Draft Decision



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A Executive Summary

The Australian Competition and Consumer Commission (“**the ACCC**”), in earlier price determinations, has set ULLS prices below cost. While there was investment in CAN infrastructure prior to those determinations, investors in competing infrastructure would now prefer to purchase ULLS at below-cost prices rather than continue investing in the expansion of their networks,

For whatever reason the ACCC priced ULLS below cost in the past, Telstra’s ordinary access undertaking for ULLS dated 3 March 2008 (“**Telstra’s Undertaking**”) provides an opportunity to rectify the error. A decision to accept Telstra’s Undertaking and to set ULLS prices closer to the levels determined by the TSLRIC+ of an efficient new entrant is a decision to promote new entry into the market, to facilitate enduring and effective facilities-based competition, and to eventually eliminate the need for declaration of ULLS. A decision to reject Telstra’s Undertaking is a decision to perpetuate mistakes of the past, to undermine continuing investment in customer access networks, to outright reject the goal of facilities based competition and hence ensure the industry remains reliant on the regulation of resale competition for as long as telecommunications services are required by consumers.

The ACCC has, in its Draft Decision, chosen the latter. However, to do so, the ACCC has had to adopt some extraordinary assumptions and positions:

- **The ACCC chooses to assume a new network build for some inputs and an old network build for others, whichever reduces the TEA model’s cost estimate.** Specifically, the ACCC assumes that the TEA model should model the costs of a network provider that benefits from the cost savings associated with building a network (and carrying out trenching work) over many past decades, while also benefiting from the cost savings associated with building a network today (using the latest technologies and most efficient practices). As hard as one might try, a network provider can have a network that is new or old, not both.
- **The ACCC uses the tilted annuity formula to push cost recovery far into the future, allowing it to set low prices today.** The extent of the ACCC’s backloading is shown with the modelling used by the ACCC to set current prices (\$12.30 to \$16). The network cost component of prices, under those determinations was assumed by the ACCC to increase 50% in 9 years, over 100% in 15 years and 200% 23 years. The ACCC is required to adopt the same backloading to artificially reduce in the short term the cost calculated by the TEA model. The price increases required under this approach to ensure cost recovery ever occurs lack all credibility, and hence greatly increase the risk being placed on the access provider; yet the ACCC pretends that the provision of ULLS at regulated terms is a low risk activity, which merits a correspondingly low cost of capital.
- **The ACCC has now indicated it needs to review whether TSLRIC+ suits its agenda.** This is despite many years of strong support for TSLRIC-based pricing for ULLS (even in a pricing principles report the ACCC published 3 months after Telstra lodged its undertaking) and the persistent endorsement of the TSLRIC+ standard by the Tribunal.

- **The ACCC finds that access seekers have a “right” to below cost access despite the fact that they will earn substantial margins at a \$30 price for ULLS in Band 2 areas.** Using data published by Optus and iiNet, financial analysis shows that at a \$30 ULLS price: Optus will earn 55.67% (\$187m pa) EBITDA and 46.75% (\$157m pa) EBIT, and iiNet will earn 50.91% (\$93m pa) EBITDA and 40.62% (\$74m pa) EBIT.
- **The ACCC has to adopt unprecedented inputs for the TEA model’s result to be below \$30.** The ACCC assumes that 100% of trenching is undertaken in turf, which implies that all roads, footpaths, driveways in Band 2 areas of Australia are turf. The ACCC adopts a WACC that is 93 basis points below its WACC determined for the same period in June 2008 despite a global financial crisis that is making it more difficult by the day for firms to raise capital. And as explained above, the ACCC backloads depreciation to such an extent that virtually no capital recovery would occur during the term of the Undertaking but provides no recompense for the greatly increased risk this back-loading causes.

Telstra urges the ACCC to recognise the importance of encouraging competitive investment in customer access networks in Band 2 areas, and reverse its Draft Decision to reject Telstra’s Undertaking.

B Principles for consideration of the reasonableness criteria

1. Before responding to the detail of the ACCC's claims, Telstra believes it is crucial to establish some principles that should frame consideration of whether access charges are reasonable pursuant to s152AH of the Trade Practices Act 1974 ("**the Act**"). This section discusses those principles. It starts by considering the difficulties inherent in the setting of access charges, and the approach regulators, governments and authorities on regulation have adopted in the face of those difficulties. On that basis, the discussion then turns to the specific concerns Telstra has with the principles the ACCC employs in its approach to regulatory costing in the Draft Decision.
2. The main points to emerge from the following discussion are that:
 - Regulators, governments and authorities on regulation have recognised the paramount importance of promoting efficient investment by providing for full recovery of efficient costs.
 - Failure to allow such recovery undermines investment not only in the regulated service (and in substitutes for that service, such as facilities that might otherwise be built by access seekers) but in all services actually and potentially subject to regulation.
 - Regulated entities cannot have confidence that costs will be recovered if regulators do not adopt cost standards that are consistent, predictable and transparent.
 - The ACCC, in its attempt to derive a low estimate of costs, appears intent not only on abandoning its long-standing commitment to TSLRIC+ but on replacing that cost standard with a jumble of approaches in which it adds estimates derived using the lower of differing costing bases. The resulting estimate of total costs would have no economic meaning and seems unconnected to any consistent concept of (physical or financial) capital maintenance.
 - The risks of regulatory capriciousness arising from the ACCC's approach are accentuated by the ACCC's attempt to shift costs from the current regulatory period to periods far in the future, without any sign that it can credibly commit to the prices that would be charged in those periods.¹
 - Such moves can only undermine confidence in the regime and indeed in the ACCC as a regulatory institution to the detriment of future infrastructure investment in Australia.

B.1 Setting access charges

3. The setting of regulated charges encounters three complex sources of tension.

¹ See section D, from paragraph 92, which shows that the ACCC's pricing for ULLS in the past has delivered low ULLS prices on the regulatory promise that the network cost component of ULLS prices will increase 50% in 9 years, over 100% in 15 years and 200% 23 years.

4. The first arises from the conflict between *ex ante* and *ex post* efficiency in the presence of lumpy investments and sunk costs. *Ex ante*, an investment should proceed if the expected willingness to pay for each unit of capacity it provides is no less than that capacity's expected average cost. This implies that if efficient investment is to proceed, the prices that can be expected by the investor per unit of capacity should at least cover the expectation of average costs. However, once the investment has occurred, each unit of demand should be served if that demand's willingness to pay is no less than the marginal cost of meeting it. As a result, once the investment has been made, to achieve allocative efficiency over the short run (and assuming away impacts on dynamic efficiency) prices should not be higher than marginal costs (at least at the margin of consumption), which usually implies prices lower than those that would allow recovery of average costs. Over the long run, however, if the combination of all prices remains below average costs the next tranche (i.e. lump) of investment efficiently required to expand or replace the network will not occur.
5. While recognising this tension, regulators in Australia and elsewhere have accepted the primacy of providing incentives for efficient investment. They have consequently sought to commit to permit recovery of sunk costs. For example, in a recent decision relating to the Electricity industry, the Australian Competition Tribunal ("**the Tribunal**") stated:²

*Not to provide a return on sunk investments just because they are sunk would involve the regulator engaging in ex post opportunism and would not be consistent with the promotion of future efficient investment and the national electricity objective.*³

6. The ACCC has recognised the importance of making a credible commitment to allow the recovery of sunk costs, as the failure to do so – a failure that generally connotes "regulatory opportunism" in which the regulator expropriates investments in the regulated entity so as to secure usually transient benefits for purchasers of its services – both deters investment by the regulated entity itself and by all those who are, or may be, brought within the scope of regulation. It also deters otherwise efficient investment by access seekers in developing substitutes for the regulated service, perpetuating regulation with all of its costs and risks.
7. A second source of tension arises from the fact that if efficient investments are to proceed, investors must have reasonable grounds to expect that their costs, once incurred, will be recovered. But changes in technology and in supply and demand generally cause costs to differ from those initially incurred or even expected. Regulators therefore need to allocate the risk to which this gives rise, noting that, ultimately, all risk must be paid for by consumers.
8. In conventional rate of return regulation, regulators effectively insured investors against cost and demand risk by allowing prices to continuously adjust so as to permit recovery *ex post* of all costs that had been prudently

² ElectraNet Pty Limited [2008] ACompT 3 [198]

³ The ElectraNet decision finds that easements ought to be valued at historical costs, though it also finds that a DORC valuation is consistent with outcomes in a competitive market, promotes efficiency and allows capital maintenance. Telstra believes that the decision errs in its conclusion with respect to easements, and that even if it did not, that conclusion would not apply in respect of any aspect of ULLS, for reasons that include: (1) as the statutory criteria applicable in respect of ULLS require a finding that charges that are consistent with outcomes in a competitive market, promote efficiency and allow capital maintenance are reasonable, TSLRIC+ estimates, which apply a comparable methodology to DORC in being forward looking (rather than based on costs previously incurred), and hence will have each of those positive attributes the Tribunal finds in DORC, are reasonable; and (2) the assets at issue are not perpetual, and are each capable of being replaced in the long run.

incurred *ex ante*. This had the merit of reducing the risk premium investors required, albeit possibly at some cost in terms of incentives for efficiency. More recently, regulators have tended to place cost and demand risk more squarely on the regulated firm. In the case of telecommunications, one form this has taken is the periodic redetermination of costs on an efficient basis, including through modelling the costs that would necessarily be incurred in providing the regulated service by a hypothetical new operator.

9. Rate of return regulation on the one hand and regulation based on determining and re-determining the level of efficient costs on the other clearly differ in how they allocate the risk of cost and demand changes. However, consistently and properly applied, both of these approaches are capable of supporting efficient investment and, in that sense, are each capable of providing the basis for a “regulatory compact” or “bargain” that promotes the long-term interests of end-users. What matters is that investors can count on consistent application of the approach, both in each regulatory proceeding and over time.
10. For example, regulation on the basis of forward looking costs (as in the use of TSLRIC+) frames the regulatory compact in terms of the regulated entity being able to recoup the costs a hypothetical new operator, operating on an efficient basis, would expect to incur for the service, as evaluated at the time of the regulatory proceeding. Obviously, as a practical matter, no regulated entity could continuously update its capital stock so that it always reflected that which would be selected by a “new build” operator. However, an entity could value its assets on the basis of the costs of such an operator, writing those assets up or down in each period on the basis of expected changes in the costs such a “new build” operator would incur. Assuming these estimates of expected changes were unbiased (in the statistical sense, i.e. they were no more likely to be too small than too large), and that forward looking costs were properly estimated, three broad results would hold:
 - The present value of the expected revenue stream in each regulatory period would equal the sum of expected costs in that period (what the Australian Energy Regulator has recently referred to as the ‘present value principle’)⁴;
 - Netting off current (operating and maintenance) costs, the present value of the expected revenue stream arising from a succession of redeterminations of efficient costs would equal the value of the opening regulated asset base and of expected efficient additions to that asset base; and
 - Efficient additions to the asset base could be reasonably expected to recover their costs.
11. In other words, consistent application of the efficient cost standard should allow expected cost recovery, which is both an integral element in the regulated entity’s legitimate expectations and essential if efficient investment is to be promoted, not only in the regulated service at issue but in substitutes for that service and more generally, in all services actually or potentially affected by regulation. However, if some elements of cost are determined in a

⁴ Australian Energy Regulator *Electricity transmission and distribution network service providers - Review of the weighted average cost of capital (WACC) parameters: Explanatory statement*, December 2008, p.110

way that allows less than the amount a hypothetical new operator would incur, then the present value principle is breached, and the regulated entity's expectations and investment incentives would be adjusted correspondingly.

12. This brings us to the third source of difficulty, which arises from the tension between the inherent complexity of regulatory price setting, including those resulting from its multiple objectives, and the need for predictability and credibility in the regulatory compact. Nothing sends a signal more chilling of investment than the inappropriate exercise of regulatory discretion or even the threat of such inappropriate exercise.

13. The High Court only recently emphasised this in proceedings in which it upheld a finding by the Tribunal that the ACCC, in reaching an access pricing decision, had “*put aside any well recognised asset valuation methodologies and had been idiosyncratic*”.⁵ Importantly, the High Court noted a principle that is no less true in telecommunications than in other industries, namely that:⁶

The greater the degree of uncertainty and unpredictability in the regulatory process, the greater will be the perceived risk of investment.

14. It is for this reason that such great emphasis has been placed on consistent, predictable and transparent application of regulatory standards, including as they relate to cost measurement, by governments, regulators and authorities on regulation, both in Australia and overseas.

15. Examples of this emphasis are provided by decisions of the Australian Energy Market Commission and the Ministerial Council on Energy to effectively proscribe revaluations of the costs of existing electricity network, and Council of Australian Government guidance on appropriate asset valuation methodologies to apply to electricity and water infrastructure.⁷

16. Overall, without such consistent, predictable and transparent application of decision-making standards, principles and models, any regulatory system will lack credibility as to current and future cost recovery, increasing (to again echo the High Court) “*the perceived risk of investment*” and correspondingly raising the required rate of return, to the detriment of consumers.

17. In short:

- There is wide regulatory acceptance of the importance of promoting efficient investment;⁸
- Efficient investment requires a reasonable expectation of full cost recovery; and
- No such reasonable expectation can be held by investors absent the consistent, predictable and transparent application of decision-making standards, principles and models.

⁵ *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* [2007] HCA 44, [92]

⁶ *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* [2007] HCA 44, [49-50], emphasis added.

⁷ See National Electricity Rules, Schedule 6A.2.1 (f) and Schedule 6.2.1. National Competition Council *Guidelines for the application of Section 3 of the CoAG Water Reform Agreement*, p.A.1 and CoAG Communiqué Attachment A Report on Electricity Reform, Para 3(b) 19 August 1994.

⁸ For example, this is key component of the objectives of the national access regime (Trade Practices Act., s.44AA), energy access regimes (National Electricity Law, s.7), and Part XIC (where, however, this guidance is complicated by multiple layered objectives).

18. As well as being important in themselves, these principles illuminate three issues central to Telstra's concerns about the ACCC's Draft Decision. These issues, which are elaborated on below, involve:

- The appropriate standard for assessing whether a cost model is reasonable;
- The need for the chosen approach to costs to be applied consistently, both in each determination and as between determinations; and
- The extent and consequences of regulatory risk.

B.2 Appropriate standards for regulatory costing

19. Regulatory costing is inherently complex, and forward looking costing especially so. Telstra's TEA model provides a far more detailed and granular depiction of the CAN than its predecessors did or than comparable TSLRIC models overseas do. That said, the TEA model does not seek to re-optimize every aspect of the network, including the location of pillars and exchange buildings, nor does it calculate O&M expenses from the bottom up. In Telstra's view, far from making the model or its estimates unreasonable, anchoring these elements in the reality of the network ensures that the TSLRIC+ estimates produced by the TEA model are reasonable, enhances the model's reliability, and is consistent with best practice regulation.⁹

20. This is because seeking to determine these inputs from a blank slate would not only greatly complicate the modelling, but would also introduce significant error and arbitrariness. It is extremely unusual for a large scale TSLRIC model to determine O&M and indirect expenses and investments using a bottom-up approach.¹⁰ This is quite simply because there is no accepted methodology that could be used to derive and verify the estimated quantum of expenditures required to run a network as large and diversified as Telstra's from the bottom up. Equally, altering the location of pillars and exchange buildings is not only unlikely to materially reduce costs but, more importantly, would require ensuring that the estimated locations were physically possible – for example, that they respected basic constraints associated with terrain, land use and planning restrictions. Again, there is no analytical methodology that can undertake this type of exercise on a reliable basis at acceptable cost. It is consequently unsurprising that such approaches have not been adopted in large scale TSLRIC models internationally.¹¹

21. A model can be reasonable, in other words, without fulfilling every counsel of perfection. Moreover, given that acquiring and processing information is costly, no modelling exercise that is efficient, in the sense of balancing the costs of refinements with the benefits, will ever seek complete optimisation. Additionally, attempting such complete optimisation in areas where there are

⁹ A more detailed discussion can be found in sections D and E below.

¹⁰ Instead, the pragmatic approach of applying O&M factors to investment costs is adopted. See, for example, Ovum which has stated that "It is not unusual to calculate [O&M] factors using a top-down approach" [Ovum (2008), *Review of the Economic Principles, Capital Cost and Expense Calculations of the TEA Model*, 6 August 2008, at page 44; equally MJA states that "...MJA also agrees that the estimation of operating costs and support costs using cost ratios is a widely accepted approach" [MJA (2008), *Review of the TEA Model*, 12 August 2008, at page 12].

¹¹ Models that alter the locations of pillars have been developed (for example, the PIE II model), but they do not take into account the feasibility of the pillars' 'hypothetical' locations. In Telstra's experience, no model of a large scale public network alters the locations of exchange buildings.

no well-accepted methodologies for doing so inevitably increases the risk of arbitrariness, both in the modelling and in its evaluation by the regulator, increasing uncertainty and regulatory risk overall.

22. As a result, a heavy burden of proof should be borne by those who claim that further optimisation, above and beyond that widely used in existing TSLRIC+ models, is required. That burden should require those parties to demonstrate that such optimisation is material, feasible at reasonable cost, and worth doing.
23. The Tribunal has, in the past, itself recognised this point. In its decision on the Vodafone undertaking, the Tribunal accepted that there are practical considerations that limit the extent to which one can prove costs are efficient outright and that those practical considerations should not be ignored.¹² The best that can be done, in Telstra's view, is to do as the TEA model does – begin with Telstra's database of known rights of way in almost every populated street in Band 2 areas, optimise the conduit routes for the CAN, adopt best practice engineering rules and apply current asset prices to calculate the replacement cost of the CAN. Such an approach, as it starts from the actual network, ensures the resulting model will not violate any engineering, planning or land use constraint, while at the same time optimising within those constraints.
24. Telstra does not accept the ACCC's view that further optimisation is material, feasible or desirable with respect to the TEA model. For reasons detailed below in response to the ACCC's findings on individual input values, the ACCC has failed to credibly show that further optimisation can be achieved and is likely to be material. Indeed, the optimisation the ACCC seeks is ill-defined, with the ACCC providing no examples of what further optimisation might be possible, let alone practical, and seemingly unable to demonstrate that that theoretical further optimisation is a common feature of the TSLRIC+ models in use internationally.
25. Despite this, the ACCC attempts to place on Telstra the burden of demonstrating that undertaking further, unspecified optimisation would not materially alter the TEA model's results. In Telstra's view, such an approach is not only substantively incorrect but unreasonable and contrary to the purpose of the statutory scheme.
26. In effect, the undertaking mechanism contained in Part XIC of the Act is intended to provide all industry participants with greater certainty and predictability than can ever be achieved through individual access arbitrations. Additionally, the undertaking mechanism should allow greater efficiency in commercial negotiation, as it establishes a clear 'default position' should those negotiations fail, thereby reducing the burden on ACCC resources. Setting an unreasonably high evidentiary standard and engaging in speculation based on possibilities rather than probabilities renders the undertaking mechanism effectively impracticable and otiose.

¹² The Tribunal, although ultimately finding that there was insufficient evidence to be satisfied that Vodafone's costs were efficient, stated (Vodafone Network Pty Ltd & Vodafone Australia Limited [2007] ACompT 1 [60]):

We consider that Vodafone is obligated to adduce some evidence that its costs were efficiently incurred. In saying this, we have no wish to impose a requirement that the submitter of an undertaking to the Commission foresee every possible speculative criticism of its investment and other business decisions. There are limits to the second-guessing of an operator's basic strategic decisions regarding the size of its network, the geographical area it seeks to cover, the level of market demand it seeks to satisfy and the manner of its product development.

27. Such an outcome is prima facie inconsistent with the statutory test of reasonableness, which plainly intends that undertakings be assessed according to a standard that it is reasonably possible to meet. Setting an impossible hurdle also acts to create unnecessary regulatory risk, which, as the High Court has found, must increase the cost of capital¹³ – an outcome plainly contrary to the long term interests of end-users.

B.3 Consistent application of the chosen cost standard

28. Regulatory risk is also unnecessarily increased, and the long-term interest of end-users harmed, by the ACCC's approach in the second area of specific concern to Telstra, namely, consistency in the application of the chosen cost standard.
29. In theory, there are several cost standards that could be used as the basis for access charging. Each of those standards is capable of being defined in such a way that, consistently applied, it would allow full recovery of efficient costs, which is a cornerstone requirement for any sustainable regulatory system. Confidence that the chosen cost standard has been and will be consistently applied in such a way is crucial if investors are to undertake investments that, once made, are sunk. This is true not only in relation to the regulated service at issue, but also in substitute services and in other services that are or could be subject to regulation.
30. The cost standard that has been chosen by the ACCC is TSLRIC+, which it has applied in all instances other than for Local Call and Line Rental services, where regulatory constraints on retail pricing meant a TSLRIC+ access price would exceed the regulated retail price.¹⁴ In choosing to rely on TSLRIC+, the ACCC has emphasised, in claims the Tribunal has subsequently endorsed, that the TSLRIC+ standard:
- Is consistent with outcomes in a competitive market;¹⁵
 - Permits full recovery of efficient costs, while not requiring end-users to pay for inefficiencies in service provision;¹⁶
 - Provides signals that can guide efficient build/buy decisions; and thereby¹⁷
 - Enhances competition in dependent markets; and¹⁸
 - Promotes the long term interests of end users.¹⁹
31. However, it is apparent that these claims would not be fulfilled were the cost standard not consistently applied. For example, it is difficult, if not impossible, to conceive of a competitive or contestable market that results in producer prices that reflect replacement costs for some items and historical or

¹³ *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* [2007] HCA 44, [50].

¹⁴ See Telstra (2008), *Telstra's ULLS Undertaking is Reasonable*, 4 April 2008, section C.2.

¹⁵ ACCC (1997), *Access Pricing Principles – Telecommunications: a guide*, July 1997, page 29

¹⁶ ACCC (2002), *Pricing of unconditioned local loop services (ULLS) – Final Report*, March 2002, p.16

¹⁷ ACCC (1997), *Access Pricing Principles – Telecommunications: a guide*, July 1997, page 29-30

¹⁸ ACCC (1997), *Access Pricing Principles – Telecommunications: a guide*, July 1997, page 30

¹⁹ ACCC (2006), *Assessment of Telstra's PSTN and LCS Undertaking, Final Decision*, 29 November 2006, p.45, see also *Re Optus Mobile Pty Ltd & Optus Networks Pty Ltd* [2006] ACompT 8, 22 November 2006 [107] and *In Re Seven Network Limited (No 4)* [2004] 187 FLR 373.

embedded costs for others, depending on which produces the lowest result. The difficulty of conceiving of any such market outcome is all the greater when it is recognised that what the ACCC proposes is that cost elements *within a single service* be valued on different bases, with some inputs having costs determined on a replacement cost basis (i.e. TSLRIC+) and others on a historical cost basis, with the selection being based on whichever produces the lowest total cost. Especially if it is true, as the ACCC contends and the Tribunal has endorsed, that competitive markets set prices on the basis of the costs of a hypothetical new entrant (see section C), then it is apparent that this mixing and matching of cost standards is inconsistent with market outcomes.

32. There is, in other words, no hypothetical competitive market that would set the price of a good so that that price reflected the historical cost of some of the inputs used in the production of the good and the replacement cost of others.
33. The ACCC's approach seems to involve trying to "have one's cake and eat it too". Thus, the costing is undertaken *as if* the network operator could simultaneously have the benefit of an efficient new network with the most up to date technology and of an embedded network which provides some historical cost savings. In reality, however, differently situated providers would have different sources of cost savings. A new entrant with best in use technology might benefit from a more feature-rich, lower cost network, while a long-established incumbent might benefit from having partially depreciated its investment. But the 'price' the new network pays for that benefit is precisely that it is not already depreciated, while the 'price' the old network pays for the benefit of being partially depreciated is precisely that it is not fully up-to-date. It makes no sense to think of a network that gets *both* the advantages of being new and the benefits of being old. Nor does it make sense to think that such a network could determine the level of prices in a competitive market.
34. Equally, a 'mix and match' approach cannot result in expected cost recovery. Thus, if the present value of a stream of TSLRIC+ valuations is equal to the present value of the opening regulatory asset base plus net additions to that asset base, then replacing some elements in that valuation with quanta determined on a historical cost basis will rarely, if ever, allow that equality of costs and expected revenues to be maintained. This is all the more plainly the case when the choice of which costing basis to apply to each element is made with the purpose of reducing the estimated total.
35. The ACCC, in defending this 'mix and match' approach, suggests that it is no different from using TSLRIC+ in respect of some declared services while using RMAC for others.²⁰ As the ACCC well knows, Telstra believes the ACCC's approach of using differing cost standards for services supplied over the same set of assets is incorrect. However, even setting that aside, the comparison the ACCC draws is flawed. It is one thing to cost an entire service on an RMAC, TSLRIC+ or other basis. It is quite a different thing to price a single service using a mix of the lower of historical cost or replacement cost for inputs.
36. The substitutions the ACCC proposes, although they are inconsistent in application from case to case and time to time, are by no means random. Rather, they are based on an approach that chooses the cost base that yields

²⁰ ACCC Draft Decision, pages 34-35

the lowest estimate of total costs. Conceptually, this is equivalent to adding together, into a single valuation, nominal and real (inflation adjusted) values, choosing between them on an item-by-item basis so as to minimise the resulting total. No economic meaning, nor any normative significance, can be attached to a cost estimate that is derived in this way. Its sole 'virtue', if it can be called that, is that it leads to a lower, albeit entirely arbitrary, number.

37. Such an approach abandons any economic rigor for the sake of minimising the cost estimate. It is no different from the approach the Tribunal quite properly rejected when, in *East Australian Pipeline Limited*, it criticised the ACCC for putting "recognised valuation methods to...one side, [in] **departing from a quest for value and entering upon a quest for some form of justice or equity**".²¹ The Tribunal has also rejected, in the past, the ACCC's decisions with respect to cost methodology which arbitrarily relied upon the lowest of a plausible range of estimates, as exposing regulated businesses to unjustified asymmetric risks.²²
38. Overall, a regulatory system in which the regulator can jumble values derived from different and inconsistent metrics in the attempt to minimise estimated total costs is plainly incapable of providing regulatory certainty or promoting economic efficiency.
39. Telstra therefore believes that the ACCC's approach, in its Draft Decision, of using TSLRIC+ based estimates for some inputs and historical costs for others is both incorrect in principle and inconsistent with the statutory criteria, including those that go to the long term interests of end-users and the legitimate interests of the access provider.

B.4 The extent of regulatory risk

40. All risk, other than that capable of being costlessly diversified away, must ultimately be paid for. Regulatory risk is no exception. As a result, avoiding unnecessary regulatory risk has been stressed as a goal by regulators, governments and authorities on regulation alike.²³ The approach adopted in the ACCC's Draft Decision is inconsistent with this principle in two important respects.
41. First, inconsistency in the choice of costing standards, and the scope to 'mix and match' those standards without regard to the economic meaning of the resulting composite estimate, itself introduces additional regulatory discretion. The fact that the resulting composite estimate has no discernible economic meaning, or clear relation to the 'thought experiment' in which the ACCC is engaged (notably that of asking what costs would be incurred by an efficient, new build, operator), increases both the regulatory discretion and the resulting additional uncertainty, as there is no external benchmark against which the estimate can be tested. That uncertainty can only increase regulatory risk, deterring investment not only in the service at issue but also in other services that are, or might be, regulated, be it in telecommunications or in other industries.

²¹ *Application by East Australian Pipeline Limited* (2004) ATPR ¶42-006 at 48,804 [19], emphasis added.

²² *Re Epic Energy South Australia Pty Ltd* [2003] ACompt 5 [90-95].

²³ See for example, Australian Energy Market Commission, Rule Determination – National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006 No.22, 21 December 2006, p.26-27, Government Response to Productivity Commission Review of the National Access Regime, Response to Recommendations 6.1 & 6.3/

42. This effect has been recognised by the ACCC itself in its decision on Telstra's application for an exemption on the supply of ULLS to SingTel Optus in areas where SingTel Optus has in place its HFC. In that decision, the ACCC argued that if it granted the exemption Telstra sought, that would necessarily lead potential builders of facilities to expect or at least fear the loss of regulated access to services.²⁴ The ACCC also claimed that the resulting chilling effect would be particularly acute as it had no means of committing to forebear from repeating its actions in future.²⁵ The ACCC, in other words, claims that it cannot bind its hands with respect to its future conduct, so that conduct that seems opportunistic in a particular instance will send a damaging signal as regards the future.
43. To the extent to which the ACCC genuinely believes those claims, it cannot dispute that adopting a 'mix and match' approach in this instance, without any basis in economic principle and substantially altering its previous approach, will send a powerful, adverse signal to investors.
44. Second, the regulatory risk thus created is made all the greater by the ACCC's transparent attempt to shift whatever costs it does recognise into future periods by means of a heavily back-loaded depreciation profile (see section D and E.8). That profile shifts the bulk of overall cost recovery to the final years of the network's life. Indeed, as noted below, under the ACCC's own modelling, the network cost component of ULLS prices would need to increase from \$9.81 to approximately \$68 per SIO per month toward the end of the ULLS assets' lives. Given that the assets which account for the bulk of the investment (conduit) are estimated to have 40 year lives, the ACCC relies upon its conduct 30 years into the future to comply with its statutory obligations of allowing efficient cost recovery. Telstra is not aware of any other regulator that has sought such large-scale deferral of cost recovery. That it provides no compensation for this increased risk only highlights the extent to which that deferral of cost recovery is unreasonable.
45. The ACCC's back-loading of depreciation sits uncomfortably with its own view, set out in its discussion of the WACC, that Telstra's investors (or the builder of a new efficient network) could benefit from the tax advantages of accelerated depreciation. Even if the tax benefits existed, which Telstra disputes (for reasons dealt with below), from an investor's perspective, the income generated by those benefits would be deferred many periods hence. As a result, the ACCC seeks to claim the cost reductions from the alleged tax benefits by front loading depreciation, while back loading the actual return of capital to the distant future. Not only is this an inherently inconsistent treatment of cost recovery but it also makes all the plainer the abandonment of a principled approach in favour of one that takes the minimisation of the resultant cost estimate as its prime objective.
46. However, the more important point is that this long-term deferral of cost-recovery must create great uncertainty as to whether that recovery will ever occur. That the ACCC is willing, as its Draft Decision suggests, to abandon a long-established approach to cost determination for the sake of artificially reducing the estimate of costs, can hardly provide investors with confidence in this respect. These doubts are necessarily strengthened by the sheer magnitude of the increase in long term charges implied by the back-loaded depreciation profile. That increase involves an almost six-fold increase of

²⁴ ACCC Telstra's exemption application in respect of the Optus HFC network – Final decision, November 2008, p.113

²⁵ ACCC Telstra's exemption application in respect of the Optus HFC network – Final decision, November 2008, p.114-115

access charges over the 40 year life of duct and pipe assets. Telstra submits that there is no record or precedent for any such increase in the history of regulated telecommunications access charges in Australia or overseas. The fact that in its Draft Decision, the ACCC claims (in Telstra's view, incorrectly) that increases in access charges can lessen competition (by reducing access seekers incentives for investment in DSLAMs, albeit for reasons the ACCC does not explain) makes it even more doubtful that an increase of the magnitude it proposes would ever actually occur.

47. From an economic perspective, there is a vital issue here of the credibility of the implied regulatory promise. The credibility of commitments becomes especially important when it is desirable for economic agents to make investments that have an element of irreversibility in reliance on actual or implied policy promises, and which hence are vulnerable to loss should those promises not be kept. Time inconsistency is the canonical form of this commitment problem in economics, with the term referring to situations in which conduct by a policy-maker that is rational *ex ante* is not (and is known not to be) rational *ex post*, so that rational actors will discount the probability of a commitment to that conduct being maintained.
48. The ACCC, in its HFC decision, itself states that it is not in a position to commit to acting in a time-consistent way.²⁶ This makes it all the more extraordinary that, in these proceedings, the ACCC would both act in ways that seemed to confirm the perception of time-inconsistency (by reversing its long-standing commitment to TSLRIC+) and then seek through the back-loading of depreciation to force investors to rely on a promise to repay costs but only in the very distant future. That the ACCC also seeks to set the WACC as if the investments involved little risk must make the contradiction even more glaring.

B.5 Conclusion

49. Central features of the ACCC's Draft Decision are at odds with the requirement of appropriate and sustainable regulation to ensure consistent, predictable and transparent application of regulatory standards, and especially of costing approaches. Rather, they suggest an approach that jumbles differing cost standards, and abstracts from efficiency criteria and notably from the goal of promoting investor confidence, all in an attempt to cobble together a low estimate of costs.
50. No economic meaning can be placed on a cost estimate that combines items based on historical costs with items valued on a replacement cost basis, with the selection seemingly based solely on an attempt to minimise the total cost. The resulting total will never allow either financial or physical capital maintenance, will not reflect the costs that would be incurred by a new entrant or by a replacement network and cannot be analogised to the outcome of any competitive market process. It is difficult to see what benefit that estimate will have other than being lower than estimates derived from more rational approaches to asset valuation.
51. The ACCC seems to believe that generating a low cost estimate is, for some reason, better than a higher number, but this is confused. Costs are costs and understating them does not promote efficiency in any respect; it merely

²⁶ ACCC (2008), *Telstra's Exemption Application in Respect of the Optus HFC Network: Final Decision*, November 2008, at page 115

distorts market dynamics, immediately makes the access provider worse off, and compromises confidence and investment in the long run.

52. There is no reason why low access prices *per se* would be in the interests of users of the declared service. Additionally, and importantly, there is no sense in which access seekers could have a legitimate interest in obtaining prices that are below a properly constructed measure of costs or which hold the prospect of distorting long term investment decisions.
53. Finally, it is obvious that cost estimates that are artificially minimised do not take adequate account of the legitimate interests of the access provider.

C The ACCC's consideration of the reasonableness of TSLRIC+ and international benchmarking is inconsistent with precedent

54. Despite many decisions over many years proposing that TSLRIC+ is the appropriate standard to apply for pricing ULLS, the ACCC has cast doubt in its Draft Decision on whether it continues to believe that TSLRIC+ pricing meets the relevant legislative criteria. In a press release accompanying the Draft Decision, that ACCC states:²⁷

Further, the way in which Telstra has applied the ACCC's long standing pricing principle in this undertaking has caused the ACCC to review the application of the current pricing principle [TSLRIC] to both the existing copper network and possible future network developments.

55. Further, the ACCC states in the Draft Decision:²⁸

However, the ACCC acknowledges that the past rationale of promoting efficient build/buy decisions through the application of TSLRIC+ may be less relevant in a regulatory environment where the competitive state of telecommunications markets is changing and there may be fewer prospects for efficient by-pass.

56. Additionally, the ACCC places a considerable amount of weight on a simplistic international benchmarking exercise in its Draft Decision rejecting Telstra's Undertaking for TSLRIC+ based prices. The ACCC states:²⁹

In this regard, while the TEA model can provide some guidance on the estimated forward-looking costs of providing the ULLS, it is not the only source that the ACCC has relied on in assessing the undertaking. In particular, the ACCC has examined international prices for the ULLS.

57. The ACCC's Draft Decision, if carried through to a final decision, would be contrary to the principles set out above and would represent an unjustified abandonment of precedent developed by the ACCC and the Tribunal to date. The precedent that has been developed by the Tribunal, and the ACCC itself, stresses that prices based on TSLRIC+ estimated with regard to an efficient new entrant's costs are reasonable and casts considerable doubt on the usefulness of international benchmarking. In particular, the precedent,

²⁷ <http://www.accc.gov.au/content/index.phtml/itemId/848849>

²⁸ ACCC Draft Decision, at page 34

²⁹ ACCC Draft Decision, at page 44

comprising the accumulated weight of repeated findings by the ACCC and the Tribunal, states that:

- The overall objective of the reasonableness criteria is to achieve the outcomes of a competitive market (section C.1);
- In competitive markets, prices are driven down by new entrants to reflect the costs of those entrants (section C.2); and,
- Except with a robust consideration of many complex factors, international benchmarking has no value in the consideration of whether prices are reasonable and, even then, it can at best only provide an alternative view point and clearly not a definitive test of reasonableness (section C.3).

C.1 The objective of the statutory criteria is to achieve the outcomes of a competitive market

58. The very reason for declaring a service under Part XIC is because competition does not exist in the market in which that service is supplied. If the market were effectively competitive, then the service would not be declared. Thus, with regard to pricing declared services, the objective of the legislative criteria is to achieve the competitive market outcomes that would exist if the market for the supply of those services was effectively competitive.

59. This 'basic objective' was emphasised by the Tribunal in its assessment of Vodafone's undertaking for MTAS. The Tribunal stated:³⁰

The starting point in assessing the submissions on this issue is, as throughout this proceeding, the principle that prices should be based on the forward looking costs of an efficient operator. The basic objective is to set prices that promote economic efficiency, which is the outcome that could be expected in a competitive market. It is because mobile termination has been declared as a service that inherently lacks the discipline of competitive forces that it is subject to Pt XIC of the Act.

Of course, the basis of reasonable prices in terms of s 152AH must proceed from the terms of that section, and it is those terms that direct the assessment process towards considerations of efficiency and competitive outcomes. [Emphasis added]

60. In its consideration of Optus' undertaking for MTAS, the Tribunal also stated:³¹

We consider that determining the costs of a stand-alone mobile operator, for the purpose of determining whether the price terms of the undertaking in relation to Optus' DGTAS are reasonable, is more consistent with the matters set out in s 152AH and the objectives in s 152AB than requiring Optus to take into account the cost consequences of it being an operator of a fixed-line network and a mobile network. If the objective of regulating a particular industry is to replicate, as far as possible, the environment of a competitive market, then it is desirable to use as a

³⁰ Re Vodafone Network Pty Ltd & Vodafone Australia Limited [2007] ACompT 1 (11 January 2007), 68-69

³¹ Re Optus Mobile Pty Limited & Optus Networks Pty Limited [2006] ACompT 8 (22 November 2006), 122

benchmark criteria or principles which would exist in a competitive market, such as determining the costs of an operator operating in that market. [Emphasis added]

61. The ACCC has also recognised this basic objective. In its guide to pricing principles the ACCC stated:³²

...the [declared] service must be supplied in markets where the forces of competition, or the threat of competition, work poorly to constrain the price of access to efficient levels. A benchmark for an efficient price is the price that would occur, given the characteristics of the market, if the access provider faced effective competition. [Emphasis added]

62. Precedent also shows that the prices that would occur in a competitive market do not reflect perfect competition but, rather, effective competition. The ACCC acknowledges that perfect competition is a theoretical construct that does not occur in practice:³³

At the theoretical level, the concept of 'perfect competition' describes a market structure in which no producer or consumer has the market power to influence prices. Economic theory suggests that perfectly competitive markets have a large number of buyers and sellers, goods/services are perfect substitutes, all firms and consumers have complete knowledge about the pricing/output decisions of others and all firms can freely enter or exit the relevant market.

In reality, these conditions are rarely found in any market or industry – even those in which competition between rival firms is relatively intense. It is certainly not a realistic threshold for fixed-line telecommunications markets given that:

- many services are provided by a small number of providers, in a situation where the incumbent as owner of the only ubiquitous local loop remains the predominant provider of most (if not all) essential inputs;*
- the industry is characterised by economies of scale, scope and density over large ranges of output;*
- services are often differentiated from each other; and*
- there are constantly evolving service types and network technologies.*

The concept of 'effective competition' recognises the practical limitations of the theory of perfect competition.

C.2 In competitive markets, prices are driven down by new entrants to reflect the costs of those entrants

63. With respect to market prices in an effectively competitive market, the following ACCC and Tribunal precedent stresses that:

³² ACCC (1997), *Access Pricing Principles – Telecommunications: A Guide*, July 1997, at page 12

³³ ACCC (2008), *Telstra's Local Carriage Service and Wholesale Line Rental Exemption Applications: Final Decision and Class Exemption*, August 2008, at page 60

- Pricing above the costs incurred by a new entrant would invite the entry of such an operator
- The costs actually incurred by an incumbent operator are irrelevant
- New entrant's costs might differ from an incumbent's
- Competitive market prices will not reflect the costs of the most efficient operator – that would be unrealisable in actuality under even the best of circumstances.

64. The Tribunal and ACCC envisage that the recovery of an incumbent's costs is not guaranteed by competition. Rather, new entrants compete against incumbents, and newer entrants compete against older entrants, until the point when prices in the market reflect efficient new entrants' costs. Thus, in terms of price outcomes, an efficient new entrant's cost is the benchmark for the price outcomes expected in a competitive market, not the costs of an incumbent operator.

65. The Tribunal considered what outcomes would eventuate in a competitive market in its decision in relation to Vodafone's MTAS undertaking. The Tribunal stated:³⁴

What outcomes would eventuate in a competitive market? In such a market, pricing above the costs that would be incurred by a new entrant having access to the latest and most cost-effective technology would invite the entry of such an operator. Regardless of the actual costs, capital equipment and modes of operation of the incumbent operators, competition would force them to price as if they were using the latest technology. This would extend beyond the age and type of their capital equipment even to the design of their networks.

66. Similarly, in its guide to pricing principles the ACCC stated:³⁵

An access price consistent with the legislative criteria is difficult to determine ex ante. The approach adopted by the Commission to guide it when performing its access pricing functions under Part XIC is to consider the constraints that would be placed on the pricing behaviour of access providers if they faced effective competition (given the characteristics of the market). Specifically prices should be consistent with the levels that would occur if the access provider faced the threat of being displaced as a supplier.

67. The ACCC acknowledged this new entrant benchmark in the Draft Decision. In this context, the ACCC stated that the intent of TSLRIC+ is (or, in the ACCC's view, was) to reflect the costs of a new entrant (or access seeker) entering the market for the supply of ULLS (building rather than buying):³⁶

The application of TSLRIC+ ('+' refers to the addition of common and indirect costs) pricing is based on the idea that, in certain circumstances, it can be desirable to set an access price that mimics the price that would prevail if the access provider faced effective competition and therefore faced the threat of being displaced as a supplier through

³⁴ Re Vodafone Network Pty Ltd & Vodafone Australia Limited [2007] ACompT 1 (11 January 2007), 70

³⁵ ACCC (1997), *Access Pricing Principles – Telecommunications: A Guide*, July 1997, at page 14

³⁶ ACCC Draft Decision, at page 34

the possibility of bypass. Such an access price could potentially promote efficient 'build or buy' decisions, such that an access seekers' decision to build by-pass infrastructure would be based on the relative resource cost of doing so. Setting prices based on TSLRIC+ was intended to create the right incentives for carriers operating in downstream markets to make the appropriate choice as to whether they should invest in their own upstream infrastructure (i.e. build) in order to provide services to end-users, or to seek access from an existing upstream provider of the listed service (i.e. buy). [Emphasis added]

68. The ACCC also states:³⁷

An important reason for preferring forward-looking costs estimates as a basis for access pricing is that access prices based on forward-looking costs will be more likely to lead to an efficient 'build-or-buy' investment decision by access seekers. The costs relevant to an access seeker deciding whether or not to build its own network are forward looking costs as currently evaluated, as these are the costs that the access seeker would actually have to incur if it constructed its own competing facilities, and the costs that it could avoid seeking access to existing facilities instead.

69. The ACCC's consultants also concur. In their review of the economic principles Ovum concluded:³⁸

The TEA model should estimate the costs that a new entrant would incur to supply the ULLS product.

70. Furthermore, a new entrant's costs can, and usually do, differ from those of an incumbent for a number of reasons. For example, an incumbent would have adopted a network design and technology based on a reasonable set of expectations at the time. A new entrant, however, might adopt a different network design and/or technology today given a different set of circumstances. Similarly, an incumbent would have adopted the most efficient construction practices and placement procedures in the past, while a new entrant might have to adopt a different set of practices and procedures today, given it faces different environmental factors.

71. In its Vodafone decision, the Tribunal determined that the assumption that the most efficient costs, whether the incumbent's or another firm's, would be brought to bear by new entry into a competitive market is "unrealisable in actuality under even the best of circumstances". The Tribunal stated:³⁹

What outcomes would eventuate in a competitive market? In such a market, pricing above the costs that would be incurred by a new entrant having access to the latest and most cost-effective technology would invite the entry of such an operator. Regardless of the actual costs, capital equipment and modes of operation of the incumbent operators, competition would force them to price as if they were using the latest technology. This would extend beyond the age and type of their capital equipment even to the design of their networks.

³⁷ ACCC Draft Decision, at page 80

³⁸ Ovum Economic Review, at page 5

³⁹ Re Vodafone Network Pty Ltd & Vodafone Australia Limited [2007] ACompT 1 (11 January 2007), 70-77.

Moreover, no exemption would be given by the forces of competition to existing operators who might be smaller and consequently, or for other reasons, have higher costs than some other operators. For that matter, competitors would not allow a new entrant the luxury of charging in accordance with the higher unit costs associated with starting up a new venture.

These are the considerations that lead to the benchmark of the costs that would be incurred by an efficient, forward looking new entrant. However, it is relevant that an efficient new entrant – even, if realistic markets are envisaged, a hypothetical one – would not itself have immediate access to the economies of scale and scope that might be achievable over time.

It can be seen that, in seeking to emulate the outcomes realisable in a competitive market, some regard must be had to the actual process (the dynamics) by which operators compete and establish themselves in markets. It is not obvious that objectives of economic efficiency lead to basing prices on the costs that an efficient new entrant could achieve after some indefinite period. Similarly, the terms of s 152AH direct the assessment of reasonableness towards some aspects of market outcomes that go beyond over-simplified assumptions that could only be appropriate were perfect competition a realistic outcome.

As might be expected, this means that the task of deciding how to assess the efficient forward looking costs of a new entrant must involve some balancing of opposing considerations and must take account of the actual markets in which the relevant services are provided. This is difficult, not least because, for example – but typically for a regulated service – a competitive market in mobile termination services can only be hypothesised. That market lacks competition because it has structural, and perhaps institutional and regulatory, features that preclude effective competition. The lack of competition is not necessarily a temporary phenomenon, nor one that will be cured by any foreseeable changes in the market itself.

The Commission has dealt with this balancing requirement and the need to take actual circumstances into account by developing the idea of an efficient operator with the scale and scope achievable by all MNOs. In present circumstances that involves the efficient costs associated with a 25% market share. (We note that earlier in its assessment of Vodafone's undertaking, when it released a draft determination, the Commission took the harder position that costs should be assessed by reference to the "most efficient operator".)

As implied above, there is sense in benchmarking against the most efficient operator on the grounds that in a competitive market no operator would be able to charge more than the most efficient operator. However, whether this would occur in real-life markets, even those considered effectively competitive but subject to normal features such as product differentiation, is another matter. The most efficient operator may well be able to price somewhat above its costs. In the sort of highly competitive market often hypothesised it is difficult to see how any less efficient operators could survive. The question is how close prices would actually be to this benchmark.

But even if the most efficient operator were chosen as the benchmark, the other difficulty remains that that operator would not be forced to base its prices on the costs of a hypothetical network optimised for all-new design and technology. For that to happen the threat of new entry would have to be based on an ability, unrealisable in actuality under

even the best of circumstances, to bring the new design and technology to bear immediately in a legacy-sized network.

It might therefore be thought that the concept of basing prices on the costs of an efficient operator with the scale and scope achievable by all MNOs represents a compromise between these somewhat offsetting elements of how a competitive market – even a hypothetical one – would operate and the outcomes that it would produce. [Emphasis added]

72. In summary, the pricing outcomes in an effectively competitive market do not reflect the perfectly efficient costs of a hypothetical operator. The real world is populated by real firms facing real challenges. The best among them are not perfect, they are simply better than their rivals.

C.3 Simplistic international benchmarking provides no guidance on whether a price is reasonable

73. In the Draft Decision, the ACCC has relied on an international benchmarking that takes into account, in Telstra's view insufficiently, only purchasing power and population density. With respect to international benchmarking, the following ACCC and Tribunal precedent shows that:

- There are many factors that need to be considered in an international benchmarking analysis
- It is insufficient to consider only a subset of these factors
- In the case of ULLS, it is insufficient to consider only purchasing power parity and line density
- Considering only a subset of factors could result in the incorrect comparison being made
- Possession of all the information required to sufficiently take into account all the factors is tantamount to a cost model

74. Generally, simplistic international benchmarking provides no evidence as to whether a price satisfies the reasonableness criteria.

C.3.1 Optus MTAS Undertaking

75. Optus, in support of its June 2004 undertaking in relation to MTAS, submitted an international benchmarking analysis based on 3 'comparator' countries: Malaysia, Sweden and the UK. However, the ACCC rejected that benchmarking study on the basis that there were at least 10 factors that should be accounted for in an international benchmarking comparison:

- Spectrum allocation;
- Network purchasing power;
- Vertical integration of fixed and mobile network operators;
- Geographic terrain;
- Population density;

- Network usage and scale;
- Land and labour costs;
- Cost of capital;
- Technology employed; and
- Exchange rate adjustments.

76. In rejecting Optus' international benchmarking analysis, the ACCC concluded that there is little point in making adjustments for only a subset of the factors that might mean costs in one country are within reason different to another's. The ACCC stated:⁴⁰

However, as outlined in the MTAS Final Report, the Commission is of the view that any analysis that attempts to make adjustments for factors that drive cost differences between international jurisdictions should be conducted comprehensively, or not at all. In other words, in the Commission's view, it would only be appropriate to adjust estimates of cost from other jurisdictions for Australian-specific factors if all major factors that influence costs in different jurisdictions could be identified and quantified. This is primarily because adjusting cost estimates from other jurisdictions for each of these factors individually will push estimates of the cost of providing the MTAS in different directions and by different amounts. Hence, it is unclear in which direction (and by what amount) a MTAS cost estimate would change if it were adjusted for all factors in combination.

For these reasons, the Commission believes that it would be inappropriate to adjust only for a subset of these factors in isolation of other possible adjustment factors as the results may be more misleading than making no adjustments at all.

77. The ACCC concluded:⁴¹

The Commission considers that, by failing to make adjustments for all of the factors which have been identified by the Commission, Analysys and CRA itself, the international benchmarking can only still be considered partial. Therefore, the Commission believes it is not a sound basis upon which to inform the appropriate costs of supplying the MTAS in Australia.

78. In the same decision the ACCC commented on the complexity of the task of international benchmarking and concluded that a bottom-up cost model (such as the TEA model) provides superior information. The ACCC stated:⁴²

In terms of identification and implementation, the Commission believes that adjusting for all the possible factors that may lead to cost differences between international jurisdictions is an extremely complex task and that some of the more complex adjustments may not be possible at all due to a lack of data.

79. The ACCC concluded:⁴³

⁴⁰ ACCC Final Decision on Optus' 2004 Undertaking, at page 117, emphasis added

⁴¹ ACCC Final Decision on Optus' 2004 Undertaking, at page 118

⁴² ACCC Final Decision on Optus' 2004 Undertaking, at page 117

Moreover, as noted by its consultant, Analysys, the possession of the information sufficient to make a comprehensive adjustment is tantamount to that necessary to construct a bottom-up model. In the Commission's view, use of the information for the latter purpose would be superior to using it for adjusting cost estimates from other jurisdictions.

80. That decision was ultimately appealed to the Tribunal. The Tribunal concurred with the ACCC, concluding:⁴⁴

We do not consider that the international benchmarking analysis proffered by Optus is of any assistance to us in determining the issue as to the reasonableness of Optus' price. The range of prices derived by CRA is so broad as to be of little assistance. Further, the nature of the adjustments made by CRA and the adjustments to which it gave no consideration, render the figures derived an inadequate comparator for Australian conditions.

In any event, the nature of the international benchmarking exercise was such that it teaches very little, or nothing at all, as to whether Optus' price terms are reasonable having regard to the matters set out in s 152AH and the objectives in s 152AB. In order to place any reliance upon the international benchmarking analysis it would be necessary to know much more about the regulatory environment within which they were determined, the state of the relevant markets and the socio economic environment in which the mobile services were operative.

C.3.2 Telstra ULLS and LSS connection charges

81. In Telstra's undertakings for ULLS and LSS connection charges, the ACCC came to a similar view as it did for Optus MTAS undertaking– that international benchmarking “cannot be used in preference to the conclusions the ACCC has drawn from applying the statutory criteria in its detailed analysis”. The ACCC stated:⁴⁵

... it is difficult to draw definite conclusions based on comparisons to overseas jurisdictions because of possible differences in a host of factors, such as the regulatory environment, market shares of non-incumbents, state of competition, technical specifications of the ULLS and LSS products and structure and configuration of PSTN networks. These differences may be significant enough that no conclusions should be drawn from simple price comparisons. As far as the undertakings assessment function is concerned, the ACCC considers that the overseas benchmark data it has gathered cannot be used in preference to the conclusions the ACCC has drawn from applying the statutory criteria in its detailed analysis of ULLS and LSS connections in Australia.

C.3.3 Telstra's 2005 ULLS undertaking

82. In support of its December 2005 undertaking in relation to ULLS, Telstra made a submission on international benchmarking for ULLS prices. On review of the ACCC's decision, the ACCC submitted to the Tribunal:⁴⁶

⁴³ ACCC Final Decision on Optus' 2004 Undertaking, at page 124

⁴⁴ Optus Mobile Pty Ltd & Optus Networks Pty Ltd [2006] ACompT 8 [296-297]

⁴⁵ ACCC 92006), Assessment of Telstra's LSS undertaking relating to connection and disconnection charges: Final Decision, April 2006, at pages 62-63

⁴⁶ Transcript of Proceedings, Telstra Corporation Ltd (No 3) [2007] ACompT 3 [384]

The Commission contends that, before international benchmarks can be resorted to, the Tribunal must be satisfied that, notwithstanding the differences between Australia and the relevant international jurisdictions, those international benchmarks are reasonable comparators. So you have actually got to be satisfied that you are comparing the Australian position to the country that is being promoted as the benchmark comparator.

83. In the Draft Decision relating to Telstra's Undertaking, the ACCC has relied on an international benchmarking that takes into account, in Telstra's view insufficiently, only purchasing power and population density (see Attachment 3, which shows, among other things, that population density has not been considered appropriately). A benchmarking study taking into account the same factors was presented to the ACCC in support of another undertaking, and was categorically rejected by the ACCC and the Tribunal. The ACCC argued to the Tribunal that taking into account only these two factors was not sufficient.⁴⁷

Well, we said that you have got to know the definition of a regulated service. You have got to know the applicable regulatory framework... the geographic price structure, the cost of capital, the prescribed cost standard, if there is one.

...but Telstra, in their response refer to developments in other countries and they refer to ULLS charges and different types of pricing models, but they only take into account, in their reply, purchasing power parity and differences in line density in the different countries. Now, we say that is not sufficient.

84. In the same matter, the Tribunal reasoned:⁴⁸

We are not satisfied that Telstra has provided sufficient evidence to support the use of international benchmarking. Although Telstra's benchmarking report contains summary information regarding ULLS regulation in other jurisdictions, in order to place any reliance upon the international benchmarking analysis it would be necessary to know much more about the regulatory framework, the cost of capital and the price structures employed in other jurisdictions. The summary tables provided by Telstra did not provide us with sufficient information to determine whether the benchmarks were reasonable comparators for Telstra's ULLS monthly charges. In addition, we are not satisfied that the adjustment of the benchmark ULLS charges only for purchasing power parity and line density takes into account all the adjustments that need to be made to the benchmark ULLS charges for them to be reasonable comparators. The costs of providing the ULLS (or similar services) can vary between jurisdictions for a myriad of reasons and we need to be careful when comparing cost estimates across different jurisdictions. The benchmarking analysis conducted by Telstra only makes adjustments for a small number of the possible differences that might exist to generate cost differences in the surveyed jurisdictions. Telstra has not provided us with sufficient evidence to satisfy us that the cost estimates from other jurisdictions considered by Telstra in its international survey do not require further adjustment before we can rely on them to assist in determining the reasonableness of a proposed access charge for the ULLS.

⁴⁷ Transcript of Proceedings, Telstra Corporation Ltd (No 3) [2007] ACompT 3 [384-385]

⁴⁸ Telstra Corporation Ltd (No 3) [2007] ACompT 3 [385-386]

In summary, we do not accept Telstra's contention that we should be satisfied of the reasonableness of Telstra's ULLS network costs by having regard to cost estimates generated by the NERA model, the historical ULLS network costs, the current ULLS network costs or international benchmarks. We have not found that these estimates provide alternative support for the reasonableness of Telstra's estimated network costs for the periods covered by the undertakings.

85. Precedent therefore clearly stresses that simplistic international benchmarks provide no evidence as to whether a price satisfies the reasonableness criteria.

C.4 Conclusion

86. By deviating from prices based on the TSLRIC+ estimated with regard to the costs of an efficient new entrant, in favour of a simplistic application of international benchmarking, the ACCC has abandoned the precedent that has been developed by the Tribunal and the ACCC itself over the last decade.
87. For reasons set out in section B above, this is both unreasonable in itself and likely to lead to outcomes that are inconsistent with the statutory criteria.

D The ACCC's assessment of the reasonableness criteria

88. The price proposed in Telstra's Undertaking is supported by the result of the TEA model which calculates the TSLRIC+ of an efficient new entrant supplying ULLS. Telstra's Undertaking, if it is accepted by the ACCC, will achieve the following outcomes that are relevant for an assessment as to whether such prices are reasonable for the purpose of the statutory test.
89. First, Telstra's Undertaking price is based on the TSLRIC+ of an efficient new entrant which, as set out in the discussion on Tribunal and ACCC precedent in section B, will reflect the competitive market outcome. The competitive market outcome is the very outcome that declaration of services is aimed at achieving. In other words, under Telstra's Undertaking price, access seekers would face similar prices to those that they otherwise would face if the ULLS market was effectively competitive and the service was not declared.
90. Second, prices that reflect the cost of a new entrant will promote the most enduring and effective form of competition – facilities-based competition.⁴⁹ Such prices mean that new entrants into the market can at least expect their financial capital to be maintained. The expectation of financial capital maintenance is a necessary condition to attract entry and encourage reinvestment. Investors will not commit funds into establishing, expanding or maintaining competitive facilities if they expect a regulator to set prices below the level that would allow them to maintain their financial capital.
91. Facilities based competition is achievable. It has been achieved in related markets, as discussed by the ACCC in its final decision to grant Telstra exemptions for the declared Wholesale Line Rental and Local Call services.⁵⁰

⁴⁹ A distinction is drawn between (i) facilities-based competition, which describes intermodal competition between firms that have their own and different networks, (ii) quasi-facilities-based competition, which describes access seekers that purchase ULLS and build their own DSLAM facilities, and (iii) resale-based competition, which describes access seekers who invest in very little of their own facilities.

⁵⁰ ACCC (2008), *Telstra's Local Carriage Service and Wholesale Line Rental Exemption Applications: Final Decision and Class Exemption*, August 2008, at page 70

92. Indeed, the beginnings of facilities-based competition for ULLS substitute services have developed in the markets in which ULLS is supplied. Throughout Australia's capital cities and major metropolitan areas there are numerous network providers relying on various technologies to deliver voice and broadband services. Competitive networks include fibre, wireless, 3G Mobile, HFC and satellite networks mainly in Band 1 and 2 ESAs (see Table 1 and Attachment 4). In Band 2 areas, 3G mobile and satellite networks provide blanket network coverage. Both these technologies are capable of providing end users with voice and broadband services. Additionally, as detailed in the following table, there exist a number of fixed networks that together cover 52 per cent of the ESAs in Band 2. These networks employ a range of different technologies and include Optus' HFC cable, TransACT's fibre network and several fixed wireless networks.

Table 1: Number of competitive networks (other than Telstra)

State/Territory	Total Number of ESAs	Number of ESAs with competitor networks	
		1 network	2 networks
ACT	1	1	0
NT	1	1	0
Qld	10	10	0
SA	10	10	0
Tas	1	1	0
WA	10	10	0
VC	1	1	0
NSW	10	10	0
Total	52	52	0

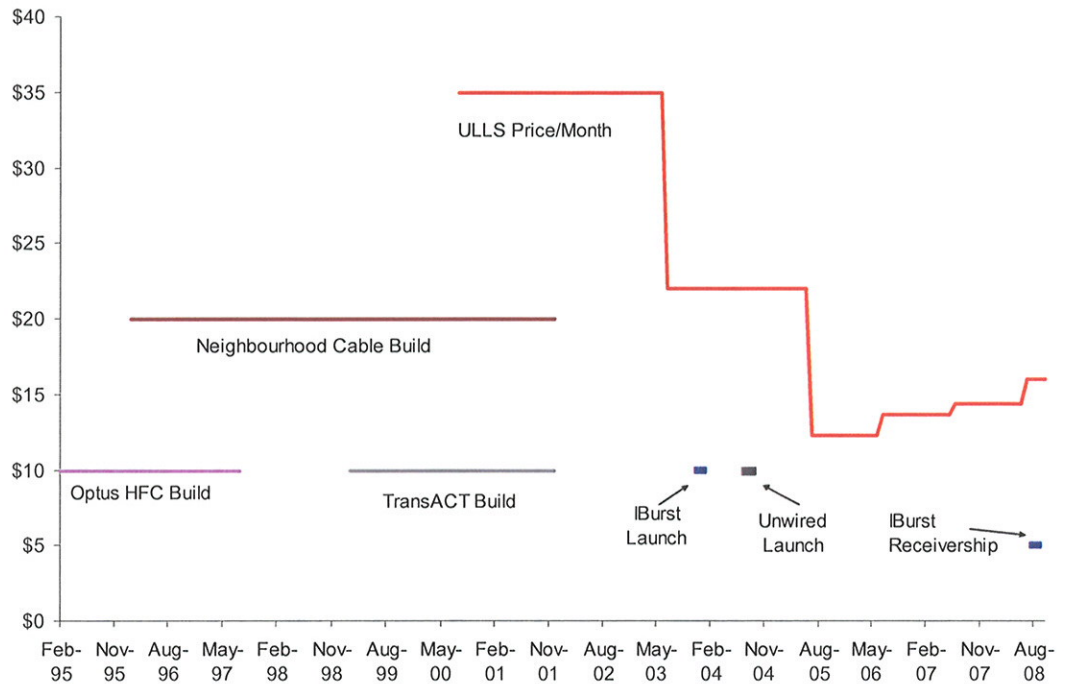
Note: networks included are Optus HFC, Neighbourhood Cable HFC, TransACT, Unwired, iBurst, Amcom's fibre network in SA and WA and e-wire's fibre network in WA.

Source: See Attachment 4.

93. It is notable, however, that the substantial facilities-based entry that occurred did so prior to the ACCC setting very low ULLS prices: \$12.30 for 2005/06 (this was made up of \$9.81 of network costs) to \$16 for 2008/09.⁵¹ This is illustrated in Figure 1 below.

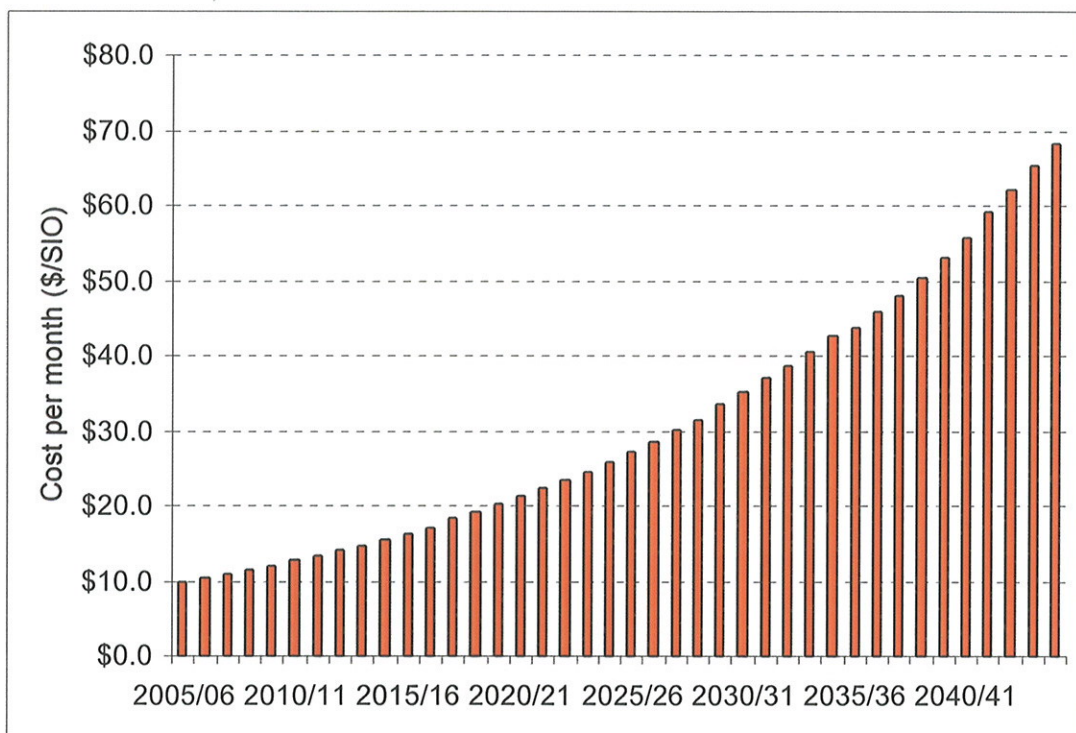
⁵¹ ACCC (2008), *ULLS Pricing Principles and Indicative Prices*, June 2008

Figure 1: Number of competitive networks (other than Telstra)



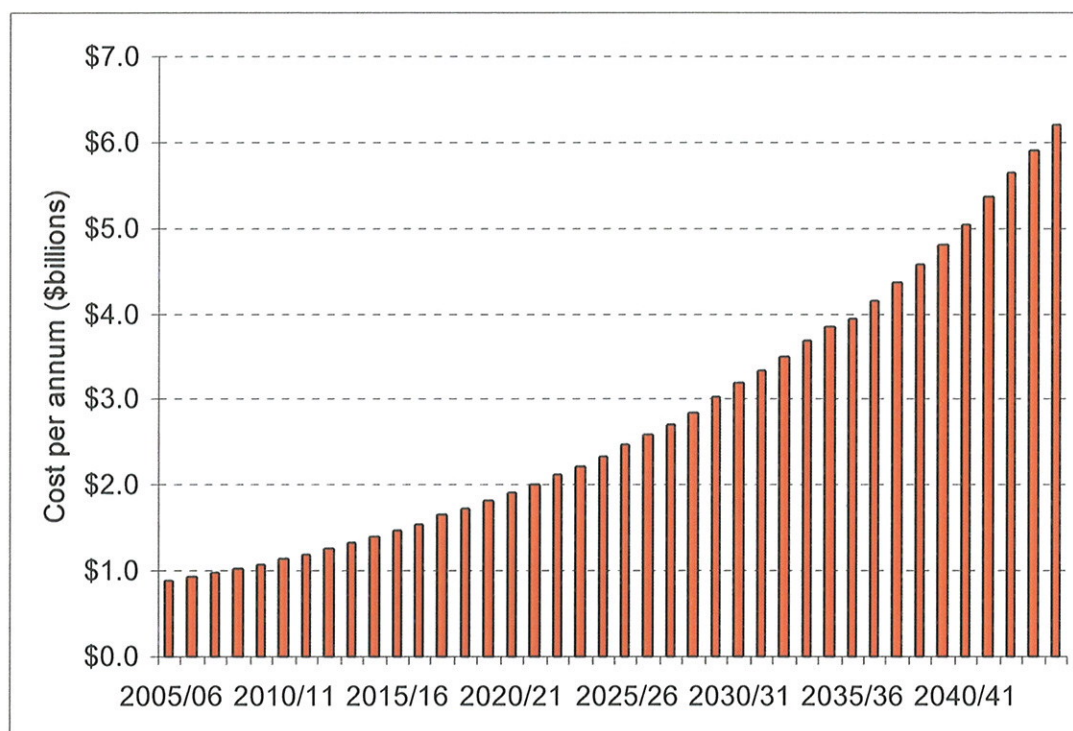
94. The current low ULLS prices are not only the result of the ACCC imposing a low valuation of Telstra’s CAN, but also of its questionable use of the tilted annuity method of calculating capital costs (depreciation and cost of capital). The tilted annuity method results in very low prices today by deferring recovery of capital costs into the future. In effect, it means the ACCC requires Telstra to recover only a small amount of the cost of the assets in early years on the promise that Telstra will be allowed to recover a much larger proportion of that cost in the future. This is illustrated in Figure 2, below, by setting out the network cost component of ULLS prices derived from the cost model used by the ACCC to set ULLS prices over the life of ULLS assets. The network costs in year one of the figure below, plus the ULLS specific cost charge, reconcile with the ACCC’s ULLS price in 2005/06. As can be seen, the ACCC’s choice of modelling methodology allowed it to set low prices in 2005/06 and at present because a substantial amount of cost recovery is held off into the future – the network cost component of prices was assumed by the ACCC to increase 50% in 9 years, over 100% in 15 years and 200% 23 years. Indeed, under the ACCC’s own modelling, the network cost component of ULLS prices would need to increase from \$9.81 to approximately \$68 per SIO per month toward the end of the ULLS assets’ lives.

Figure 2: Network cost component of the ACCC's current Band 2 ULLS prices



95. Similarly, Figure 3 below shows the corresponding annual cost recovery that is allowed by the ACCC's current prices and future price path.

Figure 3: Network cost recovery under the ACCC's current ULLS price path



96. As a consequence of those determinations, facilities-based entry has stalled with firms preferring to utilise Telstra’s network rather than their own. The ACCC’s recent pricing decisions have coincided with one facilities-based competitor going into liquidation. This is, at least to some extent, the effect of setting ULLS prices below the level that gives investors the expectation of financial capital maintenance.
97. That firms now would rather use Telstra’s network than build their own, given the ACCC’s recent pricing decisions, has been observed by a prominent European economist, Professor Martin Cave. Prof. Cave has observed that, given the ACCC’s recent pricing decisions, firms now would rather use Telstra’s network than build their own. He concludes, with respect to Optus:⁵²

The key departure in Australia from practice elsewhere is the behaviour of the major infrastructure competitor in Australia, which [is] Optus, in areas where it has built out its own end-to-end HFC network, capable of providing both narrowband [voice] and broadband services, nonetheless chooses to rent unbundled loops from Telstra as well as using its own installed network. Optus appears to “dual source” with its HFC footprint: sometimes connecting customers to its own network and sometimes using regulated access services.

⁵² Cave, Martin (2007), *Applying the Ladder of Investment in Australia*, 17 December 2007, [http://www.accc.gov.au/content/item.phtml?itemId=806382&nodeId=f5d25363c660592b183c99ca0f7c856a&fn=Telstra%20submission%20-%20Schedule%20A%20-%20annexure%201%20-%20Martin%20Cave%20Report%20\(Dec%202007\).pdf](http://www.accc.gov.au/content/item.phtml?itemId=806382&nodeId=f5d25363c660592b183c99ca0f7c856a&fn=Telstra%20submission%20-%20Schedule%20A%20-%20annexure%201%20-%20Martin%20Cave%20Report%20(Dec%202007).pdf), at page 2.