Telstra's submission in response to the Australian Competition and Consumer Commission's draft indicative prices for wholesale line rental and local carriage services

Response to a report by Frontier Economics on behalf of the Competitive Carriers Coalition (August 2006)

9 November 2006

Introduction

1. In July, the Australian Competition and Consumer Commission (the Commission) released draft indicative prices for the wholesale local carriage service (LCS) and the wholesale line rental (WLR) service, as part of the final report to its Local Services Review (July 2006).

2. Telstra responded to draft indicative price decision, in its submission (11 September 2006). That submission covered a range of topics, including the appropriate methodology for the calculation of LCS and WLR pricing and the issue of local call override.

3. In this submission, Telstra responds to claims made in a report by Frontier Economics submitted on behalf of the Competitive Carriers Coalition (CCC) (August 2006). In its report, Frontier questions the appropriateness of the Commission's use of an unbundled starting price for the calculation of the Retail Minus Retail Cost (RMRC) (part 2 of the Frontier report). Frontier also disputes the methodology employed by the Commission for the calculation of retail costs (part 3 of the report). In this submission, Telstra responds to these contentions in turn.

Response to "the use of an unbundled starting price"

4. As Telstra and the Commission have stated many times, cost-based pricing (such as TSLRIC or Current Cost pricing) is the best solution to setting of regulated prices for LCS and WLR services. Unfortunately, the Commission has stated it does not currently accept that either Telstra's PIE II model, or its own n/e/r/a model, provide reasonable estimates of the efficient costs of these services. As such, the Commission has stated that the next best solution is to set the regulated prices for these services based on RMRC — calculated using the unbundled starting local call price. Given the Commission's preference (in the interim at least) to set prices for WLR and LCS using the RMRC framework, Telstra fully agrees with the Commission that it is appropriate to set the starting price for the RMRC calculation with reference to the unbundled starting local call price (consistent with existing practice). Telstra outlined its support of the Commission's approach in its previous submission:

> *If the Commission is adamant that it will not use TSLRIC until it has reference to a more 'reasonable' model, then it is important that the Commission determine the RMRC of LCS and WLR in a manner that ensures Telstra fully recovers its efficient costs of providing the network required for the delivery of all the regulated services, and in a manner that ensures the efficient use of this network. In setting these prices the Commission must also be mindful of the regulatory constraints faced by Telstra in the retail market. These principles were articulated by Telstra in its March 2006 Submission in support of its PSTN OTA and LCS undertaking.* (Telstra, 11 September p. 11-12)

5. As noted in previous submissions, Telstra supports setting the LCS and WLR RMRC price with reference to the unbundled starting price as this methodology mitigates against the "ratchetting down" problem. "Ratchetting down" refers to the situation where Telstra's wholesale prices are determined by the movements in Telstra's retail prices. As a result of lower LCS prices, access seekers can lower their retail prices, forcing Telstra to respond, which leads to a reduction in the wholesale prices. To break this ratchetting down cycle, LCS prices are currently calculated with reference to Telstra's unbundled local call and basic access retail prices. This provides Telstra with the ability to respond to competitors by lowering its bundled prices, without these changes flowing through to wholesale prices. In Telstra's view, ratchetting down remains a substantial problem. This is the only way that Telstra is able to compete for the full bundle of PSTN services without creating a spiralling effect of ever declining wholesale and retail prices for local calls – which would obviously severely compromise the funding of the network, and the objective of efficient cost recovery.

6. It has been suggested that ratchetting down could be addressed by setting LCS prices for the duration of the regulatory period. That is, instead of incremental changes to LCS prices during the regulatory period, there would be a large change in LCS prices at the beginning of the new regulatory period. However, this does not resolve the problem. It merely delays it to the next regulatory period. This in turn would further exacerbate the problem of these services being priced at below cost.

7. The use of a bundled starting price for LCS would also limit Telstra's flexibility in setting retail prices for bundled services. For example, Telstra may in the future

want to change the structure of its retail pricing such that there will be no identifiable price for basic access and local calls. Rather, as other competitors are doing in the market, Telstra may wish to move to a structure of pricing that involves a single price for a bundle of services. This would make the use of bundled pricing for LCS impracticable. It would also limit Telstra's ability to offer innovative pricing structures in response to customer demand and competition.

8. Accordingly, despite the calls of some parties, Telstra suggests that any change to the Commission's endorsed practice of setting the unbundled retail price as the starting price for the application of the RMRC pricing principle is unwarranted.

9. In its report (section 2), Frontier make a number of claims regarding the Commission's preferred RMRC principles. For instance, Frontier claim that the use of the unbundled starting price is inappropriate as only a small number of Telstra's customers purchase unbundled local services. Telstra submits that regardless of whether or not a large proportion of customers purchase unbundled local services from Telstra, it is irrelevant to whether the unbundled price is the most appropriate one to use in the implementation of RMRC. What is relevant is whether the implementation of RMRC is such that resultant wholesale prices best reflect the cost of supply. If the retail starting price is equal to the cost of supply, then by subtracting retail costs from that retail price, one would be able to determine cost-based wholesale prices using the RMRC approach. However, Telstra's bundled local services prices are below cost, which means that the RMRC approach using bundled prices would result in wholesale prices that are also below cost. While, Telstra's unbundled retail prices are also below cost, they are above bundled retail prices. Therefore, using the unbundled prices in an RMRC calculation will result in wholesale prices that are closer to cost.

10. Frontier also claim that the low margin between retail and wholesale prices for local services is evidence that Telstra has exploited the current method of implementing RMRC pricing. Frontier state "*we do not consider that such a wedge [between retail and wholesale prices] can be justified on economic efficiency grounds*". Contrary to Frontier's opinion, there are good economic reasons for a low margin between retail and wholesale prices for local services, none of which indicate any exploitation by Telstra. For example, there are obvious complementarities between pre-selectable services and local services, which provide incentives for

access seekers to set low prices for retail local services relative to their cost — while access seekers might earn a relatively small profit from local services, pricing in this way allows them to earn high incremental profits from pre-selectable services.

11. Frontier have also ignored the constraints faced by Telstra in the form of its universal service obligations and retail price controls, which result in many retail local services having to be priced below cost.

12. Frontier claims that retail local service prices should be higher than they currently are, and that higher retail prices can be achieved by using bundled retail prices in the implementation of RMRC:

    "Consequently, there are likely to be efficiency gains from lowering price-cost margins in pre-selectable calls…and raising margins in local services (which, at least according to Telstra, are priced close to or below incremental cost)."

    "By using starting retail price alternatives that are more reflective of Telstra's actual average prices for local services…We would expect that competition should therefore drive Telstra to adopt a more rational and efficient pricing structure for its bundled services, with higher local services prices and lower call charges for long distance and fixed-to-mobile calls, and that that would be in the LTIE."

13. Frontier's logic is that when the implementation of RMRC is based on average retail prices, Telstra would have the incentive to raise retail local service prices, since this would result in higher wholesale local service prices at the next wholesale price review. It is difficult to see how this could be in the long term interests of end users. Moreover, this proposition ignores that Telstra's retail local services prices are constrained by mobile, ULLS and other infrastructure-based competition, as well as retail price controls. Hence any increase in retail and wholesale prices is likely to result in customers switching to other networks. It also ignores the fact that even if it were feasible for Telstra to raise its retail prices, access seekers would no doubt strongly oppose an increase in the RMRC wholesale price if Telstra did raise average retail prices.

14. Further, the likely effect of using average retail prices in the implementation of RMRC would not be as Frontier predict. Instead,

- In the short run, the wholesale price of local services would be lower, since average retail prices are lower than unbundled retail prices;
- Access seekers would pass on some amount of the reduction in wholesale prices to end-use customers and retain the rest in profits for their shareholders;
- To the extent access seekers do reduce retail prices, Telstra would need to respond by decreasing its own retail prices (and the ratchet effect would result in further reductions in wholesale prices, then retail prices, and so on).
- Reductions to Telstra's retail and wholesale prices further below cost, would compromise Telstra's funding of the network used to supply local services and compromise other mobile, ULLS, and other infrastructure-based competitors ability to supply local services over their own networks.

15. Hence, while adopting average retail prices in the implementation of RMRC might be to the benefit of access seekers in the short term (since their shareholders would profit from lower wholesale prices), in the long run, incentives for infrastructure-based suppliers to provide local services would be severely curtailed.

Response to "Methodology for calculating retail costs"

16. Frontier suggests that the better interpretation of a retail minus pricing rule is that the general efficiency claims should be based on providing the correct incentives for efficient entry, while minimising pressure on the access provider to adjust its retail tariffs.

17. If Frontier were actually concerned with the efficiency aspects of a retail minus pricing rule or the efficient component pricing rule (ECPR), this would lead Frontier to conclude that avoided costs should be used in the calculation of the access price. The efficiency feature of ECPR is that it results in productive efficiency by lowering the costs of total supply to society. This can only occur if the access seeker's retailing costs are below the costs that the access provider actually avoids when retail supply is shifted to the access seeker.

18. This can be simply demonstrated using Frontier's own example. Frontier assumes that Telstra's retail costs are $15, consisting of $5 fixed and $10 variable. Frontier also assumes that an entrant's cost of retailing are $12. Assuming the same split of fixed and variable costs as Telstra, this would comprise $4 fixed costs and $8 variable costs. In the absence of the access seeker, the total retail costs that society incurs are Telstra's retail costs of $15. Assume for the sake of example that access prices are set to allow this access seeker to enter the market and obtain 50 per cent of the market share, thereby letting the access provider to avoid $5 of variable costs. Under such a scenario, the total retail costs to society are $5 of Telstra's fixed costs plus $5 of Telstra's variable costs plus $4 of access seeker's fixed costs plus $4 of access seeker variable costs. This is a total to society of $18, 20 per cent above the costs to society if Telstra supplied the whole market. The reason that such an outcome is inefficient from a productive efficiency perspective is that fixed costs are duplicated and the access seeker's variable costs are not low enough to outweigh the costs of this duplication.

19. Under an access price based on avoided costs, such entry would not occur until the access seeker's costs were equal to or below the access provider's avoided costs. For example, assume that an entrants retailing costs were $2 fixed costs plus $4 variable costs. If access prices were set to allow such an access seeker to secure 50 per cent of the retail market share then the total cost of retailing to society would be $5 of Telstra's fixed costs plus $5 of Telstra's variable costs plus $2 of access seeker fixed costs plus $2 of access seeker variable costs, a total cost to society of $14. Such an outcome would be efficient because it lowers the total cost of supply to society.

20. While the avoided cost approach is one that will encourage efficient outcomes, Telstra has adopted the Commission's preferred approach of "average retail costs", which the Commission also refers to as long-run avoidable costs. The reason for this is that Telstra's overall objective is to recover the total efficient costs of the inter-exchange network across all PSTN services. In this context the individual price of one component of the service (ie wholesale local calls) is not critical so long as the prices of other PSTN services are set to allow full recovery of efficient costs. Therefore, Telstra used the Commission's average retail cost approach to set the level of IEN recovery from wholesale and retail local calls and set prices of PSTN OTA (used by both access seekers and Telstra) to recover the

remaining IEN costs. Therefore, the pricing of Telstra's PSTN services (LCS and PSTN OTA) are closely interlinked and cannot be assessed in isolation from each other.

21. Frontier also makes the point that a strength of the retail minus approach may be that it is not cost-based in the face of cross-subsidies or regulated retail prices. Presumably, Frontier is suggesting that where a retail-minus methodology results in an access price below a cost-based methodology that the retail-minus approach is preferable as it facilitates entry. However, Frontier does not explain on what basis such entry would be consistent with the long-term interests of end-users. Further, as Telstra has noted above and at length in its supporting submission to the PSTN OTA and LCS Undertakings, a retail-minus approach can be consistent with full recovery of efficient costs so long as across all PSTN services, those costs can be recovered in a competitively neutral manner.

Application of principle

Issues in the application of the principle

22. Frontier claims that there is an inconsistency in Telstra's statement in that it claims to be following the methodology used previously but it has only made a single adjustment to remove installation costs. Telstra's statement regarding methodology, is that "Telstra calculated these costs as average retail costs, consistent with the Commission's previous views on the appropriate methodology." That is, the Commission has stated on a number of occasions that it believes the appropriate methodology for calculating retail costs is a long run avoidable cost approach, where avoidability is assessed in terms of total retail supply. In other words, the Commission's methodology is an average retail cost methodology, not an avoided retail cost methodology. Telstra's approach is therefore consistent with the Commission's previously stated views regarding the appropriate methodology in that it calculates retail costs as average retail costs. Nowhere does Telstra claim to have followed the implementation of the n/e/r/a approach used in 2001, therefore, Telstra does not believe that there is any inconsistency in its statements.

Scaling-up adjustment

23. Given that the n/e/r/a report was not made public, it is obviously difficult for Frontier to understand in any detail the methodology used by n/e/r/a and the justification it provided in terms of the scaling adjustment. Frontier also does not have access to any of the responses provided in the Commission on that report. Therefore, it is difficult to understand how Frontier can simply conclude that an adjustment made in 2001 should continue to be used in 2006/07, particularly given the Commission's expressed views

24. Telstra has undertaken an analysis comparing the allocation of direct costs between wholesale and retail with the allocation of organisational costs between wholesale and retail for a range of RAF products. This analysis demonstrates the strong relationship between the proportion of direct costs allocated to wholesale and retail and the proportion of organisational (or indirect) costs allocated to wholesale and retail. Therefore, the pattern of retail and wholesale costs observed for basic access and local calls is not a reflection of a bias in the initial RAF allocation, but rather is consistent with the wholesale intensive nature of these products and with the pattern of wholesale and retail costs allocated to other RAF products.

25. Further, a bias in the allocation of retail costs could only result from either the allocation methodology or its implementation being incorrect.

26. As Frontier itself notes, the allocation methodologies embodied in the RAF have not changed since the n/e/r/a report, therefore, Telstra can only conclude that the Commission continues to view the methodologies as appropriate and the annual auditing of the RAF confirms that Telstra's implementation is correct.

27. On this basis, Telstra continues to maintain that the scaling adjustments made by n/e/r/a were inappropriate and should not be included in the calculation of retail costs for LCS or WLR.

Avoidable IT retail costs and marketing costs

28. Frontier claims that it is not clear whether Telstra or the Commission made the same assumption regarding IT retail costs and marketing costs as noted in the Commission's 2003 model prices determination. As Telstra has clearly stated in its

supporting submission to the Undertaking, all retail costs, with the exception installation costs, were included in the retail cost calculation. That is, Telstra's methodology was an average cost methodology so treated 100% of retail costs as avoidable.

Capital financing costs

29. Again, given that Frontier does not have access to either the n/e/r/a report or Telstra's response, it would be impossible for Frontier to make any assessment as to the reasonableness of the arguments and evidence provided on capital financing costs.

Reduction in USO contribution

30. Telstra suggests that Frontier should give at least some consideration to the reality of the situation at hand. Regardless of the provision of LCS and WLR, Telstra will remain the USO provider, a fact acknowledged in the Commission's own pricing principles for LCS. Including avoidable USO liabilities in the calculation of avoidable costs for LCS and WLR would simply subsidise the operations of access seekers and make it even more difficult for Telstra to recover the costs that it can clearly not avoid. Telstra does not believe that such an outcome would be consistent with the legislative criteria.

Unitisation of costs

31. Telstra does not understand what Frontier's objection is to the unitisation of retail costs. As Frontier itself notes, Telstra has unitised average retail costs using the total number of retail local calls for the relevant period and the total number of retail basic access lines.

GST adjustment

32. The GST adjustment was one made by the Commission, not n/e/r/a. For this reason, Telstra has included the same adjustment in its Undertaking prices. Contrary to Frontier's claims, the principle underlying the adjustment would appear very clear and is explained in detail in the Commission's pricing determinations on LCS. The purpose of the adjustment is to share the burden of absorbing the imposition of the GST on local call prices. Telstra does not

understand Frontier's claims that such an approach is inconsistent with competitive neutrality. In fact, Frontier's suggestion seems to be that Telstra should bear the full burden of absorbing the GST, a proposal that appears completely inconsistent with competitive neutrality.

Allocation of costs between residential and business use

33. As there is no distinction in the retailing costs between residential and business customers in the RAF, it is not possible to differentiate the retail costs for the service. Even if it were, the implications would be (if Frontier's claims are correct) a decrease in the business LCS and WLR rate and a corresponding increase in the residential rates.

Frontier's conclusions

34. Frontier concludes that if a range of the n/e/r/a adjustments are included in the calculation of access prices and if the Commission reverses its ruling on the treatment of GST then the LCS price would be 16.39 cents per call and the wholesale line rental price would be $22.45.

35. The main problem with Frontier's conclusion is that they assume that the n/e/r/a analysis started with the access prices based on average retail costs. Hence, Frontier simply deducts their chosen n/e/r/a adjustments from the Commission's prices based on average costs. This assumption is incorrect. [*c-i-c*].

36. [*c-i-c*]