Telstra's submission in response to the Australian Competition and Consumer Commission's final determination in the Declaration inquiry for the ULLS, PSTN OTA and CLLS, dated July 2006 and the Australian Competition and Consumer Commission's Final Decision in its Local Services Review dated July 2006

Addressing the pricing principles for the ULLS, PSTN OTA, LCS and WLR services and the draft price related terms and conditions for the PSTN OTA, LCS and WLR services.

11 September 2006

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Introduction

1. In this submission Telstra responds to two recent decisions by the Australian Competition and Consumer Commission ('The Commission'):

- Declaration inquiry for the ULLS, PSTN OTA and CLLS, Final Determination (July 2006)
- Local Services Review, Final Decision (July 2006).

2. Specifically, in this submission, Telstra responds to the Commission's request for comment on the draft pricing principles for the Local Carriage Service (LCS), the Public Switched Telephone Network (PSTN) Originating and Terminating Access (OTA) Service, the Unconditioned Local Loop Service (ULLS) and the Wholesale Line Rental (WLR) Service. Telstra also responds to the Commission's draft indicative price related terms and conditions for the PSTN OTA, LCS and WLR services.

3. As part of its response to the pricing principles relating to PSTN OTA and LCS, Telstra also comments on the use of Local Call Override (LCO) by access seekers, an issue that must be addressed expeditiously by the Commission.

4. This submission is divided into three main sections. Part A, considers the Commission's pricing principles for the PSTN OTA service and ULLS. In this section, Telstra also provides comment on the Commission's draft indicative price terms and conditions for the PSTN OTA service. In part B, Telstra provides comment on the Commission's draft pricing principles for the LCS and WLR services. In part C, Telstra comments on the issue of LCO.

5. One of the reasons for providing a single response to the two Commission decisions is that the LCO issue is relevant to both the pricing of PSTN OTA and LCS. It serves to highlight many of the key principles that Telstra believes the Commission must adopt in setting and assessing prices for regulated services.

Confidentiality

6. This submission and all the information contained in it is confidential to Telstra.

7. This version of the submission has all the confidential information deleted and thus may be disclosed publicly.

Part A: Pricing Principles for ULLS and PSTN OTA services and draft indicative prices for PSTN OTA

8. In this section, Telstra outlines key principles the Commission needs to follow in setting prices for ULLS and PSTN OTA services. Telstra also submits that the Commission ought to accept as reasonable the prices for PSTN OTA (and LCS) put forward by Telstra in its March 2006 undertaking.

Pricing Principles for ULLS and PSTN OTA services

9. In its Final Determination to the Declaration inquiry for the ULLS, PSTN OTA and CLLS, (July 2006), the Commission states,

   "The Commission considers that it is appropriate to maintain TSLRIC as the basis for determining prices for the ULLS and the PSTN OTA. Therefore, the Commission's draft determination is, pending further consideration, to maintain TSLRIC as the basis for determining prices for the ULLS and the PSTN OTA." (p. 56).

10. Telstra considers that in setting regulated prices for access services, the Commission ought to consider the following key principles, to ensure that it gives weight to the Long Term Interests of End Users (LTIE) and to Telstra's legitimate interests in determining access prices:

    (A) The purpose of estimating costs of various services is to ensure that the criteria in section 152AH are adequately balanced

    (B) The LTIE will not be promoted if efficient investment is not encouraged. In order to encourage this investment, the costing approach adopted by the Commission must therefore be consistent with the bedrock principle of Financial Capital Maintenance.

    (C) For the principle of financial capital maintenance to be met, the costing approach adopted must recognise the constraints under which service provision occurs. For instance, investment in telecommunications occurs in a context in which legacy assets and systems are inherited from the past, and in which investment and operating decisions are taken in a context of uncertainty as to future demand and costs — such that the pattern of investment and operational outlays that is efficient in an ex ante sense is not that which minimises costs ex post.

(D) Operating efficiently means minimising costs given these constraints, not minimising costs assuming those constraints do not exist.

(E) Telstra believes the costing methodology that best reflects these constraints, and yet is consistent with revaluing assets to take account of relative price changes, is Current Cost Accounting (CCA). Telstra believes this methodology should be used to value the initial or opening asset base. Once that initial asset base is determined, it should be updated by rolling forward, that is, by including new assets at acquisition cost and removing assets that have been fully depreciated. Once new assets had been included, they would then be depreciated in line with CCA conventions. A periodic cost study could be undertaken (say, every five years) to review allocators and ensure consistency of price trends and depreciation provisions. This is the approach that characterizes most other regulated industries in Australia.

(F) If Financial Capital Maintenance is to be respected, the costing methodology must be applied consistently across all regulated access services, as a failure to do so can result in a situation where the sum of allowed revenues is less than the total of efficient costs. Additionally, the methodology needs to be applied in a manner that is time consistent. The CCA framework, consistently applied, would meet these requirements.

(G) Were the Commission to nonetheless choose to use a TSLRIC approach as is proposed in this instance, Telstra believes it is essential that it be applied in a manner that recognizes the constraints, discussed above, that characterize all telecommunications networks. Telstra is happy to work with the Commission in the implementation of such a TSLRIC approach.

11. Assuming the Commission proceeds with a TSLRIC methodology, then in order to ensure consistency, the Commission needs to ensure total cost recovery across services, having particular regard to its stated preferences for the pricing of other services that rely on shared infrastructure (for instance the use of RMRC to price LCS and WLR) and the legislative and policy constraints faced by Telstra in the

retail market. The Commission also needs to have regard to the technical limitations imposed by the service description of the stated declared services.

The Commission needs to ensure total cost recovery across services

12. The Commission needs to be mindful in setting any prices for services such as PSTN OTA, that its approach does not preclude the efficient recovery of network costs. As it stands, the Commission provides no insight into whether its indicative prices for PSTN OTA and LCS could fully recover efficiently incurred costs. Given that full recovery of efficiently incurred costs underlies all of the legislative criteria to which the Commission is required to have regard when assessing access prices, Telstra does not understand on what basis the Commission believes its proposed prices are reasonable. Although Telstra understands that the Commission has yet to build a model to estimate such costs, this does not mean that the Commission should simply ignore the principle of cost recovery in setting indicative prices. Rather, the Commission should use whatever information it has available to it, all of which was provided by Telstra in its supporting submission for the PSTN OTA and LCS undertakings. These supporting submissions included details of Telstra's TSLRIC estimates, historic and current cost estimates and estimates of the Commission's own earlier TSLRIC study.

13. This matter is discussed further in part B of this submission.

The Commission needs to consider retail market constraints

14. Telstra also maintains, prices for declared services that are, in turn, used to provide retail services affected by retail price constraints (such as requiring average prices across Australia) must be compatible with the retail price structure. For example, if retail prices are averaged, wholesale prices must also be averaged. This consistency is required to enable Telstra to recover its efficient costs of providing services, particularly in regional and rural areas. This common sense approach is consistent with Government policy, and will provide incentives for competitive investment.[1]

[1] Telstra has discussed this issue at length in recent submissions to the Commission. See for example, Telstra's December 2005 Submission in support of its ULLS Monthly Charges Undertaking, p. 31.

15. It is critical that in setting prices and pricing principles the Commission acknowledges the constraints faced in the retail market and the consequent impacts on an access provider's ability to fully recover its efficient costs. Interestingly, this is consistent with the approach the Commission took for LCS, where it determined an averaged wholesale price because of the averaged price at the retail level (which is necessitated by government policy in support of untimed local calls). It is therefore even more confusing as to why the Commission has declined to adopt this approach for ULLS. Similarly, the Commission has proposed an averaged price for WLR, again, to reflect averaged basic access prices offered at retail, and yet by proposing a deaveraged ULLS price it will undermine the ability of this pricing to ensure full recovery of the efficient cost of the network. A wholesale pricing structure which affords access seekers the benefits of deaveraged ULL prices in urban areas, (resulting in prices below those based on averaging) and also allows access seekers the benefits of averaged WLR prices in rural and regional areas (where this results in prices below those based on deaveraging) is confiscatory and ill-advised to the point of being biased. Not only does it exempt Telstra's competitors from any requirement to help support rural and regional services when serving lucrative urban markets; it also exempts them from the requirement to pay cost based rates when providing service in the bush.

<u>The Commission needs to consider the technical limits imposed by the service description of the declared services</u>

16. Services supplied by access providers are defined by the technical limits of their service description. These limits must be recognised in cost determinations, if prices are to bear any relation to the efficient cost of supply. Costing and pricing principles must be based on a framework that is compatible with the technical requirements of the service. For instance, technology choices that are implemented in TSLRIC models must be capable of meeting the regulatory requirements imposed upon Telstra in delivering the Standard Telephone Service, meeting the Universal Service Obligation and Customer Service Guarantee timeframes. Further, no technology should be chosen that is not already in use, or that is not proven to be capable of delivering services which meet these requirements. Importantly, cost estimates for the provision of ULLS must be based upon technology capable of supporting unconditioned local loops.

Draft indicative price terms and conditions for PSTN OTA services

17. In its Final Determination to the Declaration inquiry for the ULLS, PSTN OTA and CLLS, (July 2006), the Commission states,

    "Based on the initial analysis undertaken and the fact that the indicative PSTN OTA price for 2005-06 was 1 cent per minute, the Commission considers that it would be appropriate to maintain the PSTN OTA indicative headline rate for 2006-07 at 1 cent per minute. Given the ongoing work that is being undertaken in relation to the establishment of efficient PSTN OTA costs, the Commission believes that this price-related term and condition under section 152AQA(2) will, in the interim, provide a useful starting point for commercial negotiations between access providers and access seekers."[2]

18. At the outset, Telstra is surprised that the Commission put forward draft indicative price terms and conditions prior to ruling (or even issuing a draft decision) on the reasonableness of Telstra's current PSTN OTA and LCS undertaking, which covers 2006-07 (as well as 2007-08).

19. Telstra maintains that the prices for PSTN OTA proposed in its March 2006 undertaking are reasonable and meet the requirements under the Act. As stated in its March submission in support of its undertaking,

    "Telstra believes that the proposed increase in PSTN OTA prices, which has a minimal impact on the margin available to access seekers providing fixed PSTN services, is necessary to address the declining traffic volumes on the PSTN. As Telstra has noted in public statements, usage levels on the PSTN are declining and this trend is forecast to continue over the Undertaking period. The downward trend in Telstra's PSTN volumes has been driven mainly by declines in local and national long distance volumes…"[3]

    In its March submission, Telstra also outlined a number of reasons as to why these prices were reasonable. The reasons are:

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[2] The Commission's final Determination to the Declaration inquiry for the ULLS, PSTN OTA and CLLS, July 2006, p. 58.

[3] Page 2.

- The Undertaking prices are set to recover the lower bound of Telstra's estimate of the efficient costs of the IEN.

- The lower bound of Telstra's estimate of the efficient costs of the IEN are below the level of historic costs, current costs and the Commission's own TSLRIC estimates.

- The LCS price in the Undertaking is set with respect to the methodology that the Commission has indicated is reasonable.

- As far as possible, Telstra has structured the PSTN OTA prices to encourage more efficient use of the PSTN.

- The Undertaking prices have been calculated by allocating exactly the same level of costs to all calls, minutes and customers, regardless of whether the volumes are retail or wholesale volumes. Therefore, the Undertaking prices are competitively neutral.

- The Undertakings prices pass imputation testing.

20. In summary, Telstra submits that the Commission should endorse the prices for PSTN OTA and LCS set out in Telstra's undertaking. These prices are reasonable under the terms of the statutory criteria. Failure to do so will result in access prices which are below the efficient costs of supply, and which accordingly will simply result in a windfall gain for access seekers, to the prejudice of Telstra, discouraging efficient investment in infrastructure within the industry. This is contrary to the objectives and requirements of Part XIC of the Trade Practices Act.

Part B: Pricing principles for LCS and WLR services

21. In its Final Report into the Local Services Review (July 2006), the Commission puts forward the following principles for the pricing of the Local Call and WLR services:

    "The ACCC's final determination is that an interim RMRC pricing principle should be adopted until such time as the ACCC has a robust cost model available. In implementing the interim RMRC pricing principle, the ACCC will use:

    - avoidable retail costs for the two services rather than avoided retail costs

- unbundled benchmark retail prices
- separate pricing of the two services.

The ACCC will seek to implement a cost-based pricing approach once a robust cost model, capable of producing reliable estimates of costs in all geographic regions, is available."[4]

22. The Commission notes that it has adopted the RMRC approach in favour of an efficient cost, TSLRIC approach chiefly because it does not consider that there is currently a suitable TSLRIC-based cost model. The Commission seems to believe that it is appropriate to allow resale of services in rural and regional Australia at below cost prices, because it has concerns about PIE II. It is irresponsible to set wholesale prices in these high cost areas that are known to be below cost simply because the Commission has concerns over the exact precision of the only cost model available to it. Telstra maintains that the PIE II model provides an accurate estimate of the efficient costs of building a fixed line network for the purposes of delivering PSTN telecommunications services. Telstra maintains that many of criticisms of PIE II are unfounded and ignore the inherent complexity and tradeoffs involved in the exercise. [5]

23. Irrespective of whether the Commission accepts Telstra's model or not, it is the Commission's commentary surrounding the likely prices that might be derived from such a model that is very curious:

    "While conclusions cannot yet be drawn about the results from a robust cost model, it might be expected that the results would similarly result in cost-based access prices below current access prices." (p. 64).

24. Telstra does not understand how the Commission can reach this conclusion in the absence of a so-called 'robust cost model'. It would seem that the Commission has no basis upon which to reach such a view.

25. 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

[4] The Commission's Final Report into the Local Services Review, p. 83.

[5] See further, Telstra's June 2006 Submission in support of its March 2006 Undertaking for PSTN OTA and LCS, p. 8.

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.

26. The LTIE can only be satisfied by the consistent application of sound economic principles across all services, both wholesale and retail. To do otherwise will prevent Telstra from being able to fully recover its efficient costs. This goes against the LTIE and the legitimate interests of any network provider.

Avoidable or Avoided Costs?

27. The Commission comments that Telstra has changed its view on the appropriateness of avoidable or avoided costs, with respect to the deduction of costs in determining RMRC pricing for services. Telstra remains firmly of the view that whatever methodology is used to set the price of LCS, full cost recovery across all PSTN services should not be compromised. This point was acknowledged by the Commission in its final report, however it is important to reaffirm this principle as it is fundamental to efficacy of the pricing regime in promoting the LTIE. Ultimately, whether avoided or avoidable costs are used in the calculation of RMRC, the efficient network costs not recovered from LCS and local calls must be recovered on a competitively neutral basis from other services.

28. In preparing its March 2006 undertaking on OTA and LCS, Telstra adopted the Commission's average cost approach in determining the LCS price. If avoided costs had been used instead, the only impact would have been slightly higher LCS prices and slightly lower PSTN OTA prices, but overall, full cost recovery would have still been achieved.

The Commission's indicative pricing structure for LCS and WLR is not reasonable

29. Telstra submits that the current structure of WLR and LCS prices allow for a lower local call price, that has provided the appropriate balance sought by the industry, and forms the basis upon which offers have been made to the retail market. Conversely, the proposed prices for LCS and WLR envisaged by the Commission are not reasonable. the Commission's indicative prices will prevent Telstra from

recovering the efficient costs of supplying these services. Further, unless the Commission takes action to denounce the practice, these prices have the potential to encourage the use of LCO, thereby significantly retarding Telstra's ability to recover its efficient costs of the network (see Part C below).

Part C: The Local Call Override issue

30. An important issue for Telstra, and one that is directly relevant to the draft price related terms and conditions for the LCS and PSTN OTA, is the use of LCO by access seekers.

31. The use of LCO by access seekers is inconsistent with the pricing principles applied in relation to the declared services, is inconsistent with equitable recovery of efficient costs, is highly inefficient, and distorts and discourages incentives to invest.

32. LCS involves access seekers purchasing end-to-end local calls from Telstra and reselling them to consumers. As Telstra has indicated in previous submissions on this topic, LCO arose as a method for providing local calls due to a technical loop-hole in the availability of override and the Commission's differential pricing of LCS and PSTN OTA. While LCO remains an issue for the industry even under the current level of prices in the market today, the differential between LCS and PSTN OTA has been heightened exponentially by the Commission's draft indicative pricing decision to increase LCS prices to 17.69 cents (an untimed, averaged rate) while maintaining the current PSTN OTA headline rate at 1cpm (with the timed. de-averaged rate table).

33. LCO involves access seekers procuring customers to prefix the dialling of local calls with the access seeker's specific long distance over-ride code (often through the installation of "auto diallers" or programming the customer's PABX). This leads to access seekers being charged for local calls as if they were PSTN OTA. Access seekers also use international special service codes (including 001X and 009X) and VPN access codes (including 188X codes) to achieve the same outcome. The dialling of an over-ride code has the effect of routing the call to a POI between the access seeker and access provider, as if the call were a national long distance or international call, although it is not. However, rather than being conveyed across the access seeker's long distance network (ie to another state or country), the call

is then immediately handed back to the access provider for termination in the same standard zone as it originated.

34. Over-ride codes were never intended to be used by consumers or access seekers for the provision of local calls. Rather, over-ride codes were implemented to allow consumers to select a provider other than their pre-selected provider, for the provision of STD, IDD and Fixed to Mobile services on a call-by-call basis. The fact that the Commission determined differential pricing for PSTN OTA and LCS (ie PSTN OTA has timed, geographically de-averaged rates, while LCS has an untimed, geographically averaged rate), has resulted in the use of LCO by access seekers for the provision of local call services.

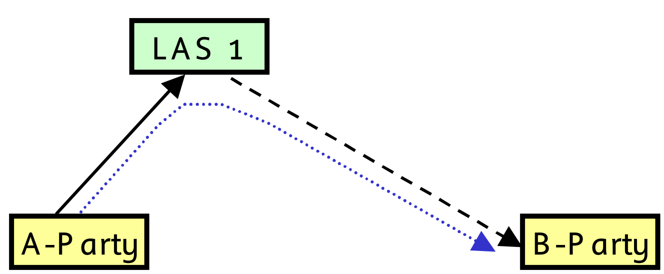
35. Specifically, the difference in price between LCO and LCS has created a regulated arbitrage opportunity for access seekers. **[C-i-C]**

Network efficiency is compromised by LCO

36. LCO gives rise to inefficiencies in the use of Telstra's network.

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

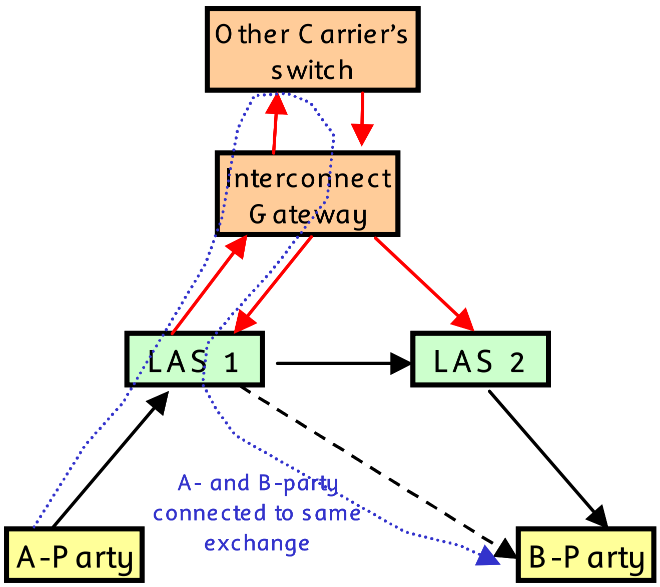
Figure 1: General LCS routing



38. In contrast, an LCO call between the same parties utilises substantially more network resources. The call will be routed from the A-party to an interconnect

gateway, to the access seeker's switch, back down to the local switch before being terminated to the B-party. Not only does this routing use more of Telstra's network resources, but it also requires access seekers to have the capacity to accommodate LCO traffic, which it simply hands back to the Telstra network. The inefficiencies of the LCO routing are depicted in Figure 2 below.

Figure 2: General LCO routing



39. The arbitrage opportunity provided by the differential proposed in the Commission's new indicative pricing between LCS and PSTN OTA is significant, and is large enough to provide access seekers with the incentive to invest in additional switch port capacity in order to accommodate LCO traffic, even though this routing is inefficient and unnecessary. It also artificially distorts investment decisions away from more efficient means of providing local services, including ULLS, LCS and direct connections. Hence, the arbitrage opportunity is clearly inconsistent with the efficient investment and use of network infrastructure criteria in the legislation, and the long-term interests of end-users, as incorrect investment signals are sent to access seekers.

Indicative prices should relate to service descriptions of the declared services

40. Telstra submits that it is imperative that the Commission ensures that its final price related terms and conditions for LCS and PSTN OTA are related to the correct

matching of the indicative prices to service descriptions for each declared service, and that it does not permit the avoidance by access seekers of paying the LCS rate as determined by the Commission for wholesale local calls via LCO. Only then will the integrity of LCS pricing principles be maintained. Access seekers should not be allowed to arbitrage and undermine those pricing principles by seeking to obtain the charges for PSTN OTA in circumstances where the service acquired does not properly fall within what is properly contemplated by that service description, in order to avoid paying the LCS price.

PSTN OTA and LCS are distinct declared services, which do not overlap, and the price related terms and conditions should be applied accordingly

41. In this regard, Telstra submits that the Commission's final decision on price related terms and conditions should make it clear that:

    (i) the indicative pricing for PSTN originating access (PSTN OA) ie: both pre-selection and override (ie: STD, IDD and FTM calls[6]) does *not* apply to LCO calls;

    (ii) that LCS pricing applies to *all* end-to-end local calls supplied by the access provider to the access seeker (ie: including LCO calls). This approach is supported by the Commission's service descriptions for both LCS and PSTN OTA; and

    (iii) even if the PSTN OTA construct is utilised to provide local calls via LCO then LCO should be priced consistently with the LCS price related terms and conditions as this is still an LCS call (as set out below).

    These statements should be made irrespective of the LCS and PSTN OTA rates ultimately determined by the Commission, for so long as LCS is priced in a different manner to PSTN OTA, the potential for arbitrage will exist.

Local calls using PSTN OTA fall within the LCS service description

42. Telstra submits that the Commission should make it clear that the indicative pricing for LCS applies to all end-to-end local calls supplied by the access provider to the access seeker, irrespective of whether these calls transit a POI. As set out

[6] As set out in the Telecommunications (Provision of Pre-selection of a Standard Telephone Service) Determination 1998 and the ACIF C515: 2005 Industry Code on Pre-selection.

below, this approach is supported by the Commission's service descriptions for both LCS and PSTN OTA.

43. Telstra submits that the carriage of local calls where the call temporarily departs Telstra's network and transmits to the access seeker's network because the end-user dials the access seeker's over-ride code, falls within the meaning of LCS as set out in Appendix C of the Commission's Final Decision in its Local Services Review, July 2006 ("LCS Service Description").

44. The LCS Service Description defines LCS as:

> "*a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone*."

45. This definition is technology-neutral. Further, consistent with industry practice, it does not limit LCS to the carriage of calls over a single carrier's network. For example, if a service provider provides an end-to-end local call to its end user customer by resupplying a call from an "A party" directly connected to Telstra's network to a 'B party' directly connected to another carrier's network, the LCS call travels over two carriers' networks. However, the access seeker still acquires from the access provider and supplies to its customer, a telephone call "from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone". Therefore, the service provided by an access provider to the access seeker remains LCS, despite the fact that the telephone call has travelled via two different networks.

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

LCO falls outside the service description of PSTN OTA

47. Telstra submits that the carriage of local calls dialled with an over-ride code falls outside the Commission's service description for PSTN OTA.

48. The service description for domestic PSTN originating access provides that:

> "*1.3.1 The service is provided on a call that is made with:*
>
> - *pre-selection; or*
> - *a AS specific code including Special Services codes and number ranges (with some exceptions) as per table POASD7; or*
> - *a long distance, international or shared operator codes dialled with an over-ride/ access code in accordance with the Australian Numbering Plan*."

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

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

    over-ride codes dialled to access local (and long distance) calls do not *fall within table POASD7, which deals with international special services and shared services codes; and*

    as domestic PSTN originating access only applies to long distance, international or shared services codes, it does not *apply to local calls.*

50. Further, Telstra contends it was clearly never intended that Telstra have an obligation to provide over-ride capability in respect of local calls. Although the drafting in the Telecommunications (Provision of Pre-selection of a Standard Telephone Service) Determination 1998 ("the Determination") is somewhat ambiguous in that it does not expressly exclude local calls, an examination of the ACIF Industry Code on "Pre-Selection - Single Basket / Multi Service Deliverer"

("the Code")7, which was registered by the ACA and the Explanatory Statement accompanying the Determination, clearly shows that the ACA did not intend to require carriers or carriage service providers to provide pre-selection over-ride in relation to local calls.

51. The Explanatory Statement to the Determination unequivocally states under the heading "Background", that:

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

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

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

The term "pre-selectable services" is defined in the Determination as meaning:

> "*…a call using a standard telephone service to:*
>
> > a geographic number or local number that is not a local call
> >
> > …"

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

> "*Pre-selectable services means a call from a Standard Telephone Service (other than a call that originates on a public mobile telecommunications service) to:*
>
> > *(a) a geographic number or local number that is not a local call;*
> >
> > …

[7] ACIF C515: 2005 Industry Code on Pre-selection is intended to replace the previous ACIF C515 2003 and ACIF C515 1999 Code. The new Code was registered on 13 October 2005. The relevant provisions of the 1999 Code are retained in the 2003 and 2005 Codes.

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

...

(g) Local Calls;

...".

52. In terms of consumer expectation and awareness, ACMA's consumer information contained on its web-site (sourced on 28 August 2006) clearly talks about the use of override to make calls as "pre-selection over-ride calls" and that these calls are "...a good option for times when you want to take advantage of special offers on *long distance or international calls* by various companies." [our emphasis][8].That is, it is clearly intended that the use of override codes is the flip side of pre-selection in that pre-selection sets the consumer's default long distance service provider but that in order to take advantage of spot specials and use another carrier other than the pre-selected carrier then the "pre-select override" code can be used. Nowhere is it stated by ACMA that an override code can be used to provide local calls. It is clear from this and many similar usages that override or pre-select override, as it is also known, is the flip side of pre-selection and relates to how and when consumers make long distance calls and which service provider they use for that service.

53. As the Commission itself notes in its Final Determination (at page 41), "[a]t the time of the deeming of the PSTN OTA in 1997, the Commission saw the service as being central to the provision of long-distance services to end-users." That is the declaration of PSTN OA was primarily intended to address the bottleneck of access to a POI (as defined) from which an access seeker can provide long distance services without having to invest in its own access infrastructure.

54. In terms of local calls (and LCO clearly pertains to the provision of a local calling service) the Commission clearly has chosen to enable regulated access to Telstra's local calling service via the LCS declared service and has noted in its Final Decision in its Local Services Review that "the use of PSTN origination and termination is unlikely to be a significant alternative to the LCS." That is, one of the strong bases on which LCS was redeclared was the conclusion that, leaving aside the growth of

[8] ACMA Consumer Fact Sheet: Your options for choosing a telephone company - - sourced from ACMA web-site 28 August 2006

ULLS and other facilities based competition[9], LCS is the primary vehicle to provide local calling services in competition with Telstra. In doing so the Commission acknowledged (refer footnote 65) that "Telstra has argued against the use of PSTN OTA for the supply of local calls…".

The impact of LCO

55. Telstra notes that the intention behind the Commission's decision to move the discount from LCS to WLR in the application of its RMRC pricing principles appears to have been designed to be relatively competitively neutral. In deriving its new indicative prices, it appears that the Commission was simply effecting a "rebalance", that took an existing discount and applied it to the service to which it related (WLR), rather than to another service (LCS). Thus, access seekers who might pay the new indicative LCS price (which has increased **[C-i-C]** to 17.69 cents/call) would be "compensated" for this price increase upfront through a lower WLR charge. It would be remarkable, and completely contrary to the objectives and requirements of Part XIC, for this proposed "rebalance" to result in a windfall gain to access seekers by allowing them to avoid paying the (higher) LCS price through the arbitrage opportunity created by LCO.

56. LCO generates significant inefficiencies. These inefficiencies occur both because the arbitrage is inconsistent with the equitable recovery of efficient costs and also because the network routing of LCO puts significantly more burden on Telstra's PSTN infrastructure, and the infrastructure of access seekers, compared with LCS. It is simply the case that LCO would not exist, if the arbitrage opportunity created by the differential pricing between LCS and PSTN OTA did not exist.

Equitable cost recovery and the effective price of LCS

57. In the Determination, the Commission's proposed LCS price for 2006/07 is 17.69 cents per call (excluding the discount for basic access). Thus, in the Commission's view, Telstra should be able to secure 17.69 cents per local call from access seekers for provision of each LCS.

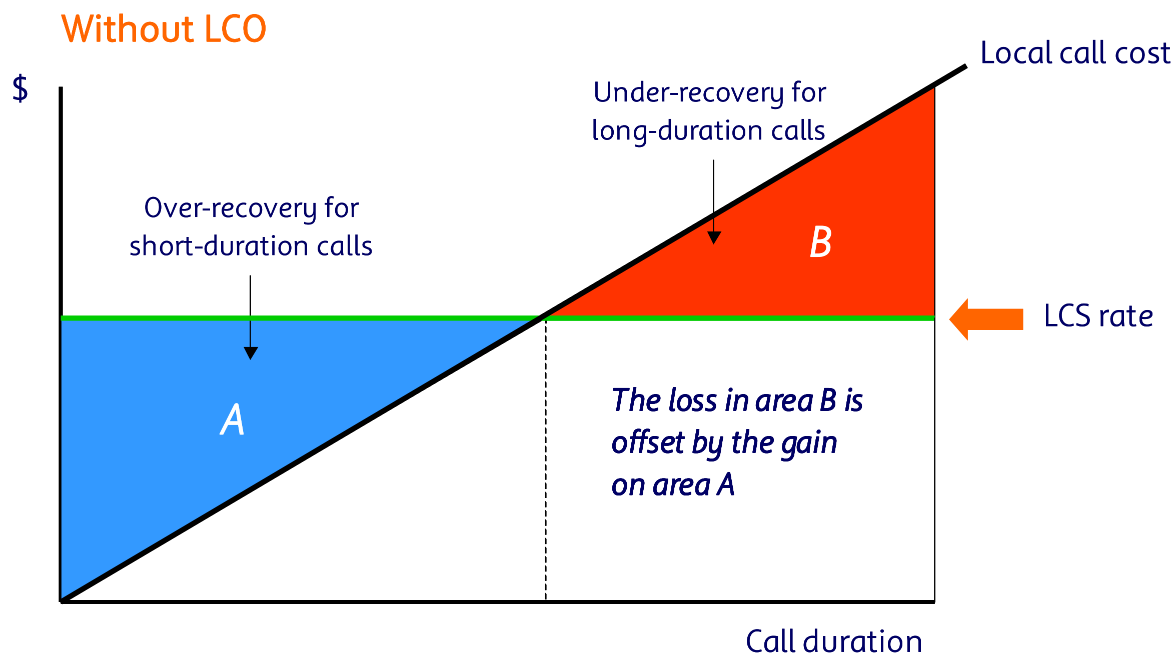
58. However, the Commission's LCS price fails to take into account the potential use of LCO by access seekers and the consequent impact for the effective contribution

[9] which Telstra addresses in other submissions regarding the appropriateness of regulation in all areas where alternative infrastructure is present and growing

that Telstra can secure toward the wholesale costs of local calls and its overall recovery of its efficient IEN costs.

59. This issue may be demonstrated by reference to figure 3 below:

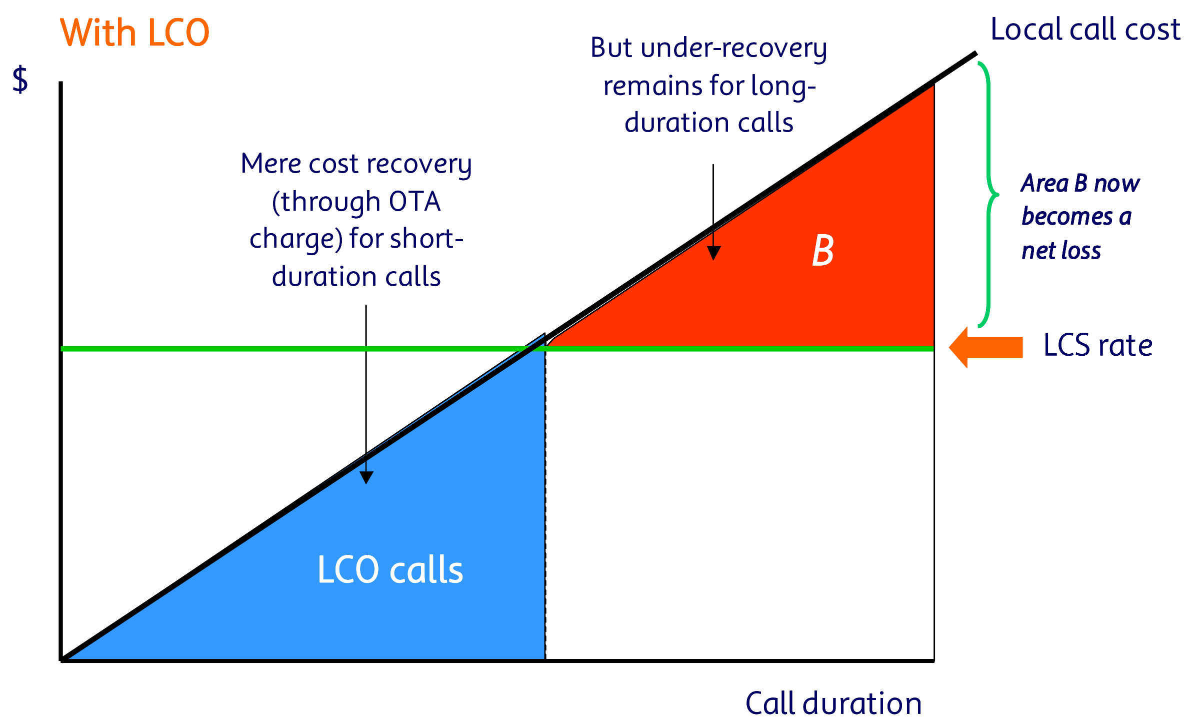
Figure 3



60. Without the use of LCO the averaged LCS rate applies to all local calls provided over the Telstra PSTN. Whilst there will be an over-recovery towards Telstra's costs of providing a local call for short-duration calls (represented by shaded area A) there will be an under-recovery of costs for longer duration calls (represented by shaded area B). The loss in area B is offset by the gain in area A.

61. However, in the scenario where the PSTN OTA is utilised to facilitate the delivery of local calls via LCO, the situation changes considerably, as demonstrated by Figure 4 below.

Figure 4



62. The use of LCO means that for shorter duration calls the OTA rate is likely to apply which means mere cost recovery applies[10] (represented by the "LCO calls" shaded area in Figure 4). For longer duration calls, the (lower) flat LCS charge will apply meaning that area B in Figure 4 now becomes a net loss representing the amount of under-recovery permitted by the arbitrage opportunity.

63. With an increase in the local call price to 17.69 cents per call (as proposed by the Commission), and with most existing arrangements for LCO expiring, Telstra expects the incidence of LCO to increase substantially. This will severely undermine the Commission's pricing principles, as well as significantly reducing access seekers' contribution towards the cost of providing local calls, and therefore the IEN.

64. The potential reduction in revenues created by the arbitrage opportunity between LCS and LCO even at 2005/06 LCS rates for PSTN OTA and LCS, exacerbates the issue of cost recovery in an equitable manner. In contrast, under Telstra's PSTN OTA and LCS Undertaking of March 2006, the proposed LCS price of 9.28 cents per

[10] Cost recovery assumes that the PSTN OTA rate is set to recover Telstra's efficiently incurred costs.

call and a PSTN OTA rate of 2.18 cpm in 2006/07 would act to minimise the adverse arbitrage effects of LCO and facilitate full recovery (and no more) of Telstra's IEN costs.

65. It is clear that the Commission must act to eliminate the arbitrage opportunity created by its proposed new indicative prices: the failure to do so (for example, by at least specifying that LCO should be priced equivalently to LCS, and potentially also reverting to the previous structure of a low local call price and higher wholesale line rental price consistent with previous industry practice) is unreasonable and unjustifiable, and one which also fails to take sufficient account of the legitimate business interests of the access provider, and the LTIE.

66. As the benefit of using LCO and the arbitrage created by the Commission's proposed pricing would greatly increase, in the absence of a solution to address the arbitrage Telstra would be required to fund an increasing share of the costs associated with local calls supplied by access seekers.

Dealing with the problem

67. For all of the reasons outlined above, LCO is a problem which must be addressed by the Commission, particularly given the increased arbitrage opportunity that is created by the proposed new indicative prices.

68. Telstra submits that the Commission should address the LCO problem by confirming that LCO calls should be priced as LCS calls. This would remove the problems raised by LCO, whilst allowing access seekers to use LCO should they wish to do so by negotiating commercial arrangements with Telstra, as has occurred in the past. Such commercial arrangements would reflect the fact the wholesale price of a local call determined for the regulated LCS service also effectively sets the price for the carriage of all wholesale local calls originated and terminated on Telstra's network irrespective of how they are routed. In that way, any supply of the LCO will not undermine efficient cost recovery or promote inefficient use or investment in infrastructure.

69. An alternative solution to address the arbitrage between LCO and LCS if it was determined that LCO did fall within the PSTN OTA service description (which Telstra, for the reasons set out above, strongly refutes) lies in eliminating the price discrepancy between the two services. While there are a number of ways

that this can be achieved in practice, the most practical solution (given the policy requirements for retail pricing parity) would be to accord LCO an untimed, geographically averaged rate to match LCS.

70. Given the very high costs of call conveyance in rural areas, Telstra does not believe that the Commission should set LCS prices on a timed, geographically deaveraged basis, because this would not be consistent with current retail pricing principles, is a backhanded way of dealing with the arbitrage problem and would not be workable in practice.

According LCO an untimed, geographically averaged rate to match LCS

71. This option involves charging LCO calls on the same basis as LCS calls, that is, charging LCO on an untimed, geographically averaged basis.

72. The benefits of this approach are that it removes the arbitrage between LCS and LCO and facilitates efficient costs recovery across the LCS and PSTN OTA services. Hence, it would remove the incentives for the inefficient use of the PSTN to route local calls and would allow Telstra to at least recover the RMAC revenue from all wholesale local calls.

73. This approach would also accommodate the Commission's suggestion of moving from RMAC to TSLRIC. That is, if the Commission determined that LCS should be priced on a geographically averaged, timed TSLRIC price in the future, then LCO would also be moved to a timed, geographically averaged TSLRIC price.

74. Given that this approach is consistent with the service descriptions, addresses arbitrage, allows Telstra to recover at least the RMAC of all wholesale local calls, encourages the efficient use of Telstra's network and efficient investment by access seekers and provides for a smooth transition to TSLRIC-based pricing for both LCS and LCO, this is Telstra's preferred approach.

The LCO arbitrage opportunity and the LCS price

75. Telstra wishes to emphasise that the problems identified above with the LCO arbitrage opportunity arise irrespective of the level of the LCS price. It is important to appreciate that LCO is not an issue which arises merely in the context of the Commission's setting a draft indicative price for LCS of 17.69 cents.

All of the issues raised by Telstra in this submission continue to apply at lower LCS prices. The problem arises due to the averaged and untimed nature of LCS versus the timed, geographically de-averaged nature of PSTN OTA pricing making an artificial manipulation of traffic and routing arrangements by access seekers attractive. Setting a higher LCS price and a lower PSTN OTA rate simply heightens the problems associated with the differential pricing between LCS and PSTN OTA.

76. Clearly this outcome is totally lacking in logic and common sense, sends confused and distortionary signals to the industry and promotes only inefficiency and the artificial evasion (by switch based carriers) of paying the full price for a wholesale local call carried on Telstra's network. Telstra will substantially under-recover its efficient costs of providing local calling services which are not sufficiently met by access seekers using its network to provide local calls if the LCO arbitrage is mandated.

77. The Commission must confirm urgently that LCO is LCS and that any use of LCO via PSTN OTA arrangements falls outside the service description of the declared PSTN OTA service.