

**Telstra's submission in response to the
Local Services Review**

April 2006

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A. Executive summary

1. On 17 March 2006 the Australian Competition and Consumer Commission (the '**Commission**') released its Local Services Review: Draft Decision on whether or not the ACCC should extend, vary or revoke its existing declaration of the local carriage service (the '**draft decision**').
2. Unbelievably, in a period of intense and ever increasing competition, the Commission has proposed extending declaration into new areas, rather than rolling back unnecessary regulation. The proposed re-declaration of the Local Carriage Service ('**LCS**') and declaration of a Wholesale Line Rental ('**WLR**') service is not in the Long Term Interest of End-users ('**LTIE**'). Proceeding to implement this draft decision can only harm consumers and stifle innovation and real competition in the Australian telecommunications industry.
3. In its submission to the Fixed Network Services Review, Telstra argued that regulation should be focused on ameliorating market failures in 'bottleneck hotspots' only. Regulation needs to be targeted, efficient, simplified and streamlined in order for it to be in the LTIE.
4. In its draft decision, the Commission has adopted the very antithesis of this approach. By not having regard to the state of competition in many parts of Australia, and by failing to adequately and impartially assess the costs and benefits of regulation, the Commission has opted for blunt, broad and blinkered outcomes.
5. The Commission has not demonstrated that it has adequately examined the state of competition in the markets for LCS and WLR, and therefore it cannot reasonably be satisfied that declaration is in the LTIE.
6. The draft decision to declare LCS and WLR reveals a disappointing preference on the part of the Commission in favour of increasing regulation — even in the acknowledged absence of compelling benefits and poorly understood costs and risks. This is at odds with best regulatory practice and is against international trends.
7. Even in areas where the Commission is uncertain whether declaration is in the LTIE, the Commission prefers to press ahead and regulate. Rather than declare services only where doing so is clearly in the LTIE, the Commission has expressed a preference to declare everywhere, and leave industry participants to seek exemptions to try and roll-back regulation where the Commission has over-reached. The Commission's

approach shows little regard to the very real costs and risks of declaration, and leads to unnecessary uncertainty in the market.

8. The Commission's draft decision was made without fully investigating the state of competition. If the Commission had thoroughly examined the state of competition, it would find that competitive infrastructure has either been rolled out or is viable in many areas. The geographic areas where competitive infrastructure exists are at least the six metropolitan local call areas of Sydney, Melbourne, Brisbane, Perth, Adelaide and Canberra. Declaration of the LCS or WLR in these areas is patently unnecessary, inefficient and not in the LTIE.

B. Regulatory principles the Commission should adhere to when declaring services

10. When deciding whether to declare a service and the boundaries of that declaration, the Commission should be guided by the following principles in assessing whether declaration is in the LTIE:

- Services that are, or are likely to be, subject to effective competition should not be declared as regulation would needlessly distort the market, shackle participants and lead to inefficient outcomes. This principle was recorded, in the explanatory memorandum when Part XIC was introduced into the Trade Practices Act 1974.¹
- Even when services are not, or may not be, subject to effective competition, the Commission must still properly assess whether there are future benefits to regulating access that outweigh the attendant costs. This requires an assessment of the impact of access regulation on innovation, investment and therefore on future competition. This principle is relevant to both the “promotion of competition” and “efficient investment” criteria in the LTIE.
- Access regulation, like all regulation, should be imposed in a way that minimises regulatory costs. For example, relying on the exemptions process to wind back an overly broad declaration fails the regulatory cost minimisation test, as it involves two regulatory processes where one, properly conducted process would suffice.

¹ Trade Practices Amendment (Telecommunications) Bill 1996, Explanatory Memorandum, p. 41.

It is not intended that the access regime embodied in this Part impose regulated access where existing market conditions already provide for the competitive supply of services. In considering whether a thing will promote competition, consideration will need to be given to the existing levels of competition in the markets to which the thing relates.

C. The Commission has not adhered to these regulatory principles

11. The regulatory principles set out above are uncontroversial, yet Telstra believes it is necessary to restate them because they seem largely absent from the draft decision. In particular:
 - the Commission's proposed declaration will cover areas where there is effective competition, and so is overly broad;
 - the Commission has not demonstrated any clear benefits from regulation;
 - the Commission has not properly weighed the costs of declaration; and
 - the Commission is not looking to impose declaration in a least cost manner.
12. Each of these deficiencies is expanded on below.

The Commission's proposed declaration will cover areas where there is effective competition, and so is overly broad

13. In its submission to the Fixed Network Services Review, Telstra argued that regulation should be focused on ameliorating market failures in 'bottleneck hotspots' only. Regulation needs to be targeted, efficient, simplified and streamlined in order for it to be in the LTIE.
14. It is disappointing, that in its draft decision, the Commission has adopted the very antithesis of this approach. By not having proper regard to the state of competition in many areas of Australia, and by failing to adequately and objectively assess the costs and benefits from declaration, the Commission has opted for blunt, broad and blinkered outcomes.
15. In particular, the Commission has sought to impose declaration in local areas as diverse as Sydney and Smithton without first thoroughly investigating the level of competition (existing and emerging) in these areas. This should be the first and most important step in any declaration process, so that remaining bottleneck hotspots can be identified and the declaration, if necessary, properly targeted. For the Commission to declare either LCS or WLR, it is incumbent upon the Commission to demonstrate the evidence it has used to satisfy itself that declaration would be in the LTIE.

16. Declaring a service, whether it was previously declared or not, and whether it is for two years or two months, brings with it significant costs and risks. The Commission cannot be satisfied that declaring a service is in the LTIE without presenting compelling evidence and clear reasons to support this decision.
17. In forming a view on whether declaration is likely to be in the LTIE, the Commission must have regard to the level of existing and emerging competitive infrastructure throughout Australia, as the presence of competitive substitutes is fundamental to the assessment required by Part XIC. As outlined by Telstra in its submission to the fixed network services review, by the end of this year well over half of Australian households will have access to competitive infrastructure. In the presence of competitive substitutes and alternative infrastructure, continued (or increased) declaration is unlikely to be in the LTIE.
18. Given its extensive information gathering powers and the lengthy LCS review time period, Telstra is surprised the Commission's draft decision does not display any such support for its analysis.² Even without the Commission's information gathering powers, it is relatively simple to gather detailed information on competitive DSLAM deployments — extensive information is on many firms' websites. For example, both iiNet and TPG include very specific information on actual and planned DSLAM deployment on their websites.³ In addition, third-party websites, such as DSLAM Watch, provide extensive data on DSLAM deployment.⁴ In Appendix A to this submission, Telstra provides further details of competitive infrastructure in Australia. The information provided in Appendix A is indicative only, as Telstra believes the Commission is best placed to conduct an audit of competitive infrastructure on an exchange by exchange basis. . This public, readily available data suggest a level of competition in many areas that is starkly at odds with the Commission's suggestion of a 'paucity of options'.

² Rather than undertaking this type of analysis, the Commission has sought to discredit previous submissions made by Telstra, without referring to the context in which these submissions were made. For example, the Commission refers to Telstra's submission in support of its ULLS monthly charges undertaking and its comment that customers are giving up a second line (p. 49). Telstra cannot see the relevance of this submission to the question of whether declaring LCS is in the LTIE. Further, Telstra's statements regarding fixed to mobile substitution are not contradictory (as the Commission suggests) as both statements accept that fixed to mobile substitution is occurring and differ only in terms of timing (p. 48-49).

³ See the following websites for details: <http://www.iinet.net.au/dslams/updates/> and <http://www.tpg.com.au/dslam/>

⁴ Accessible at <http://www.dslamwatch.com.au>

19. Telstra believes that the Commission must closely examine all competitive infrastructure on an exchange by exchange basis, or on a local calling area basis, together with competitive substitutes, to assess where there is effective competition. Absent this analysis, any declaration is likely to extend to areas where competition is effective, which is not in the LTIE.

The Commission has not demonstrated any clear benefits from regulation

20. Even in those areas where there is not currently infrastructure-based competition or where infrastructure-based competition is unlikely to emerge in the short-to-medium term, it is incumbent upon the Commission to demonstrate how declaration of LCS and WLR will be in the LTIE.

21. In its draft decision, the Commission stresses that the LTIE will be improved by increased competition. However, the Commission does not provide any compelling evidence to show how the present declaration of LCS has improved real, facilities-based competition. Indeed, the Commission appears to have little confidence in its declaration promoting facilities-based competition:

The ACCC considers that there is no firm evidence on which to form conclusions as to whether the declaration of the LCS has promoted competition by improving the conditions for facilities-based entry. (p. 93)

22. Also, on page 24 of its draft decision the Commission states:

The LCS may or may not have provided an effective stepping stone towards these developments.

23. Telstra finds it extraordinary that, notwithstanding these concerns, the Commission has in fact decided to *expand*, rather than further limit the scope of local services regulation.

24. Despite the lack of evidence in support of the stepping-stone model, the Commission appears unwilling to remove, or even reduce, resale-based regulation. The Commission appears to favour a smorgasbord approach where access seekers are offered all manner of declared services irrespective of whether this is in the LTIE. As Telstra argued in its submission to the fixed network services review, the stepping stone model has proven to be a failure and is being wound back throughout the world. Instead of enabling a smooth transition from resale to facilities based competition, regulators have found that competitors quickly find the access option that gives the greatest margin.

25. The Commission also appears to be focusing on the past impacts of the declaration as the method of determining the costs and benefits of re-declaring the services. Past experiences are relevant, but only insofar as they relate to the likely present and future impact of declaration. Even if the Commission feels that its 1999 declaration of the LCS has been beneficial, it has failed to adequately demonstrate how any of these benefits provide support for re-declaring LCS or the declaration of an entirely new service (WLR) from July 1 this year.
26. The Commission has also failed to outline the benefits that can be expected from declaration of the WLR service. In fact, the Commission has been unable to identify any evidence of market failure brought about by the present non-declaration of this service, and seems to be basing its decision to declare largely on the premise that WLR was 'de facto declared' under the 1999 declaration of the LCS.⁵
27. Finally, the Commission has dismissed the fact that Telstra has willingly supplied WLR, together with LCS, for many years⁶ and the Commission has itself based pricing decisions for LCS on the basis of the avoidable costs of wholesaling basic access. The Commission has failed to make a compelling case for WLR and how declaration would be in the LTIE.

The Commission has not properly weighed the costs of declaration

28. Aside from failing to provide evidence on how declaration will provide any real benefits to end users, the Commission has failed to demonstrate that it has adequately taken into account the inherent risks and costs involved in declaring a service. The Commission states in its draft report (at page 9):

Telstra's incentives to efficiently invest in replacement technologies to deliver voice services will not be unduly affected by the regulation of these services as long as the pricing approach does not lead to either under-recovery (reducing their capacity to invest in new networks) or over-recovery (reducing their incentive to invest in more efficient technologies) of costs for these services.

29. Putting aside the implication that the Commission can accurately determine a price that would not allow for over or under recovery (which, based on past evidence, Telstra

⁵ See, for example, p79 of the ACCC's draft decision: "While not currently declared, the line rental service is at present provided and priced through the supply of the local carriage service, and thus is effectively declared on a de facto basis."

⁶ See p. 80 of the draft decision, where the ACCC rejects Telstra's statement that it has never refused to supply basic access on reasonable terms and conditions by saying that "The ACCC does not consider that Telstra's arguments are credible."

doubts) this statement ignores the fact that stopping over-recovery can significantly inhibit investment incentives.

30. More than this, by its own admission the Commission proposes to set RMRC prices below cost. In part, this appears predicated on the Commission's view that Telstra's PIE-II model does not produce reasonable TSLRIC based prices. Given that the Commission has no up-to-date alternative model, it is hard to see how the Commission can reasonably make this statement, even with the caveat that it cannot be definitive. If the Commission feels that it needs to develop a new cost model (as appears to be the case from statements made in the draft decision), then Telstra looks forward to working with the Commission in its development. More importantly, irrespective of the development of such a model, the Commission must ensure that its pricing principles guarantee the recovery of Telstra's efficient costs. The PIE-II model provides a reasonable estimate of these costs. Those costs will not be recovered based on the RMRC construct proposed by the Commission.
31. The Commission also needs to guard against arbitrage when declaring components of services. By separately declaring WLR, in addition to the multitude of already declared fixed line services, including the ULLS, the Commission is simply promoting arbitrage opportunities, rather than encouraging efficient use of (and development of new) infrastructure.
32. The problems of over zealous access regulation are well-recognised — for example, the recent report of the Canadian Telecommunications Policy Review Panel states (at page 3-35):

One argument advanced in favour of a very broad scope of mandated access is that such an approach would promote all forms of competition by making it easier for competitors to resell any portion of the ILEC's network that they want. However, in the Panel's view, a broader scope makes the distortion of entry and investment decisions more pervasive. For this reason, a broad scope of mandated wholesale access would not in fact promote all forms of competition. Rather, it would promote only one form of entry (i.e. resale), thus perpetuating disincentives for new entrants to build facilities and entrenching the ILECs' [substantial market power] over the network and its elements.
33. The Panel therefore recommended limiting access regulation to only true bottleneck facilities. The Commission would, in Telstra's view, be wise to adopt a similar approach.

The Commission is not looking to impose declaration on a least cost basis

34. The Commission seems to have given little consideration to ensuring regulation is imposed in a least cost manner. Declaration across a broad geographic area will inevitably involve regulatory over-reach. However, rather than ensure that the scope of declaration will only include bottleneck hotspots, the Commission asserts that if this is an issue, industry participants are free to apply for exemptions in affected areas.
35. Telstra believes there are significant flaws in the Commission's view that it can make a broad re-declaration of the LCS (outside CBD areas) and rely on the exemption process to limit the scope of that declaration. Calling on service providers to seek an exemption shifts the burden of regulatory analysis from the Commission to the industry, forcing the industry (which does not have the Commission's information gathering powers) to demonstrate that regulatory roll-back is warranted. The onus ought to be on the Commission to demonstrate that regulation is necessary. The Commission has failed to do this with its draft decision showing a preference for a broad-brush declaration, even in areas where there is effective competition. This will result in multiple regulatory processes when one would have sufficed. This cannot be in the LTIE.

D. If the Commission is determined to proceed, it should at least minimise harm

36. For all of the reasons outlined above, the Commission has failed to demonstrate that it has evidence to satisfy itself that re-declaring LCS or the declaration of WLR is in the LTIE.
37. However, if the Commission is determined to re-declare LCS, it should limit the declaration to only those local areas that remain 'bottleneck hotspots'. Telstra provides indicative information in Appendix A, showing that competitive infrastructure is in place in many areas. This is not an exhaustive list, and all exchange service areas should be assessed by the Commission using its statutory information gathering powers.
38. If a WLR service were to be declared, the service description should be limited to the essential characteristics of basic access. It should also be consistent with the service that has already been provided to, and accepted by, the industry for many years. Telstra provides an example of a suitable service description in Appendix B.
39. In the event that LCS and WLR are declared, the pricing principles need to ensure full recovery of efficient costs (this is discussed further in Appendix C).

Appendix A Evidence of competition

40. In this appendix, Telstra presents publicly available data which indicates that there is competitive infrastructure installed in many exchanges throughout Australia. Indeed, as at 1 September 2005 in most metropolitan areas, competitor infrastructure was accessible to over 70 per cent of Telstra lines, as shown in Table 1.

Table 1. Number of Telstra lines reached by competitor infrastructure, by metropolitan area

	Number of Telstra Lines	Percentage of Lines Reached by Competitors' Infrastructure
Sydney	1.6 million	84%
Melbourne	1.2 million	82%
Brisbane	0.6 million	67%
Adelaide	0.5 million	83%
Perth	0.6 million	92%
Canberra	0.14 million	72%

This data were originally presented in *Attachment A* to Telstra's February 2006 submission to the ACCC's review of fixed network services. Competitor infrastructure includes DSLAM and Optus HFC coverage. Other than Optus, Telstra sourced DSLAM data from competitor websites, Optus' DSLAM roll-out was estimated.

41. As outlined in the main body of this submission, Telstra believes that regulation should be limited to those areas that remain bottleneck hotspots. Telstra does not believe the Commission has given due regard to the extensive competitive infrastructure in making its draft decision. For declaration of the LCS and WLR services to be in the LTIE, the Commission would need to believe that effective competition was not feasible, even though competitive infrastructure is in place.
42. The most relevant competitive infrastructure Telstra believes the Commission should have regard to are:
- Alternative networks, such as Optus' Hybrid Fibre Coaxial Cable (HFC) Network and Transact's Canberra based network. These networks are used to provide voice, pay TV and broadband services.
 - Competitive DSLAM rollouts, which are used to provide voice and broadband services, and may also be used to provide content services in the near future.
 - Mobile networks, which are used to provide voice, content and data services, with 3G networks capable of providing mid range broadband speeds.
 - Wireless networks, which are used to provide broadband and voice services. For example, Unwired provides wireless broadband services, and also provides a

VOIP voice service. Unwired operates in the Sydney metropolitan area, and is now entering the Melbourne metropolitan market.

43. All of these alternative networks and competitive substitutes contribute to a vigorously competitive market. The infrastructure based competition they provide means that continued declaration of LCS and the proposed WLR declaration are demonstrably not in the LTIE.
44. In the rest of this appendix, Telstra presents a quick snapshot of some of the competitive infrastructure in place. Telstra focuses on competitive DSLAM deployment and the Optus HFC network in this appendix. The information provided is by no means exhaustive. Telstra believes the Commission is best placed to conduct a thorough audit of competitive infrastructure, and recommends that the Commission does so, so that regulatory decisions are made with the correct empirical information to hand.

A.1 Competitive DSLAM Rollout

45. Telstra’s view is that the extensive rollout of competitive DSLAMs throughout Australia provides a competitive constraint on Telstra, challenging any notion that Telstra has market power. Competitive DSLAMs are being used to provide both voice and broadband services, with competitors offering compelling bundles to attract customers.
46. Table 2 shows that each of the main metropolitan areas in Australia are well served with competitive DSLAMs. All metropolitan areas have at least 80 per cent of the ESAs with competitive infrastructure.

Table 2. Metropolitan areas with at least 70 per cent of ESAs covered by competitive infrastructure, by State and Territory

Metropolitan areas	Number of ESAs with competitive infrastructure	Percentage of competitive ESAs in the area
Sydney	88	98
Melbourne	89	85
Brisbane	44	90
Adelaide	27	93
Perth	38	100
Canberra	16	80

Sources: Company websites. Optus deployment estimated based on most likely geographic spread.

47. Optus, iiNet and Primus are the three largest players in this space, with all planning on DSLAM rollouts of between 300-350 each. Telstra believes this rollout will give each carrier coverage of the majority of the five main metropolitan areas. Goldman Sachs

recently compiled the DSLAM rollout of these players and a few others, as shown in Table 3 excerpted from the report:⁷

Table 3. Telstra Competitors DSLAM Deployment Intentions

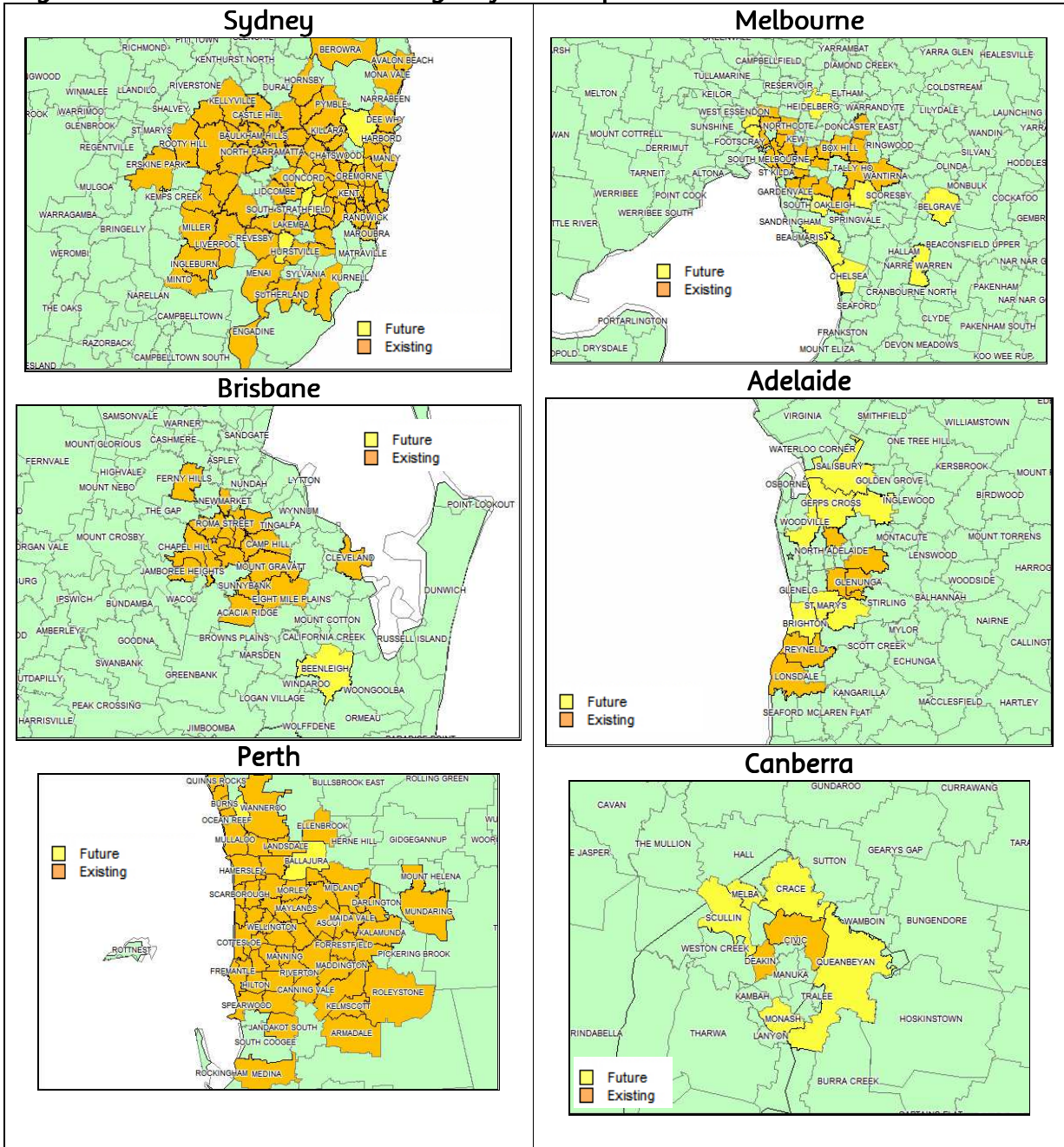
	DSLAMS Installed		Completion Date
	Today	Planned	
Optus	100	340	Not known
iiNet	200	350	January 2007
Primus	200	250 – 300	December 2006
PowerTel	120	152	December 2006
Nextep	95	95	

Based on Company data, GSJBW Research estimates.

48. Other than Optus, data on DSLAM rollouts are available freely on competitor websites and sites such as DSLAM Watch. Detailed graphical data, showing the metropolitan rollout of DSLAMS by iiNet and Primus are presented in Figures 1 and 2.

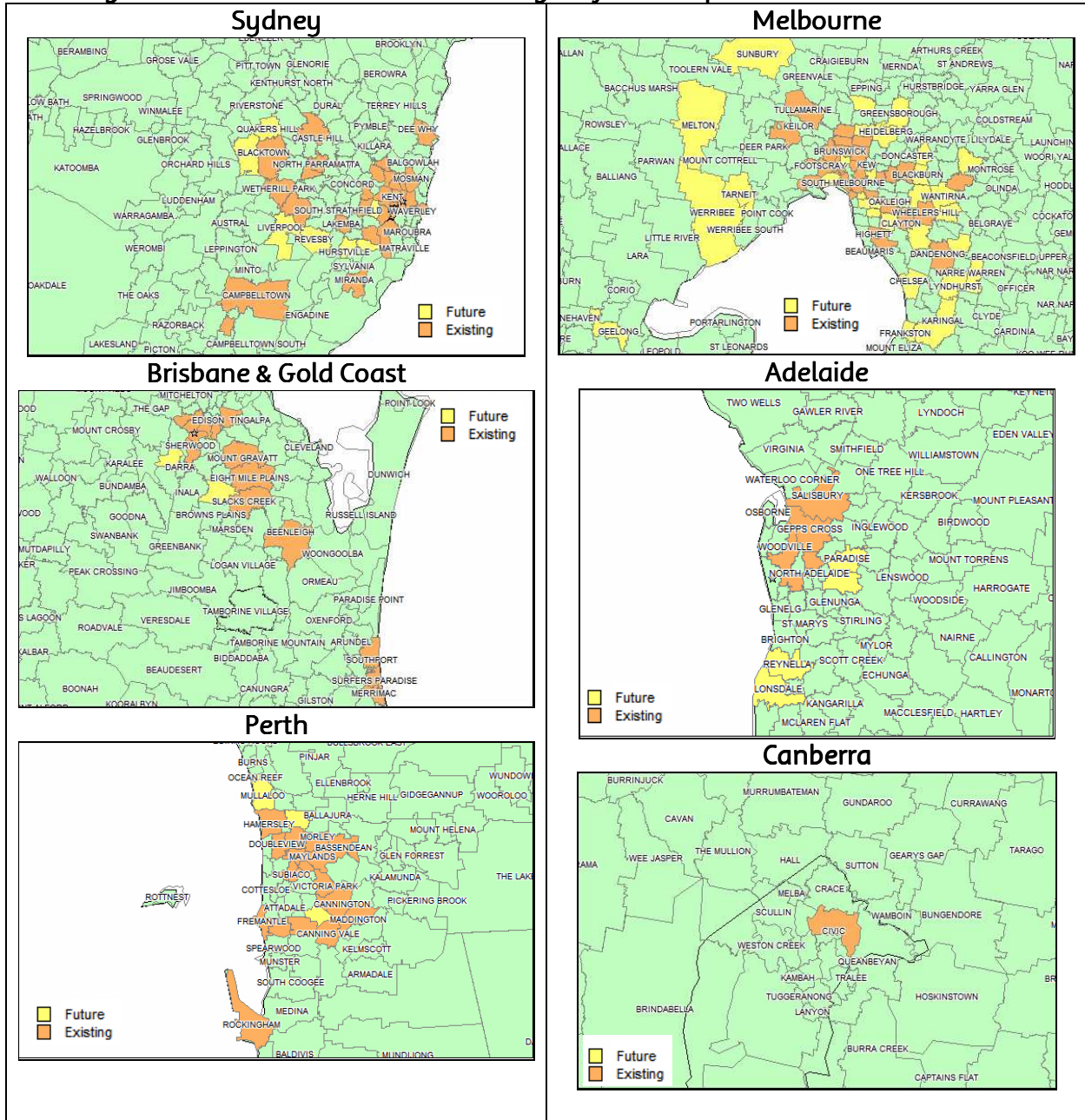
⁷ Goldman Sachs JB Were, 29 March 2006, Telstra fixed line: surely FY06 will be the worst of it?, p. 5

Figure 1. iiNet DSLAM rollout, by major metropolitan centres



Sources: iiNet website, as at 20 February 2006.

Figure 2. iPrimus DSLAM rollout, by major metropolitan centres



Sources: iPrimus website, as at 20 February 2006.

49. In total, based on competitor websites and an estimate of Optus' DSLAM locations, the likely geographic spread of the active and planned DSLAMs is as shown in Table 4 .

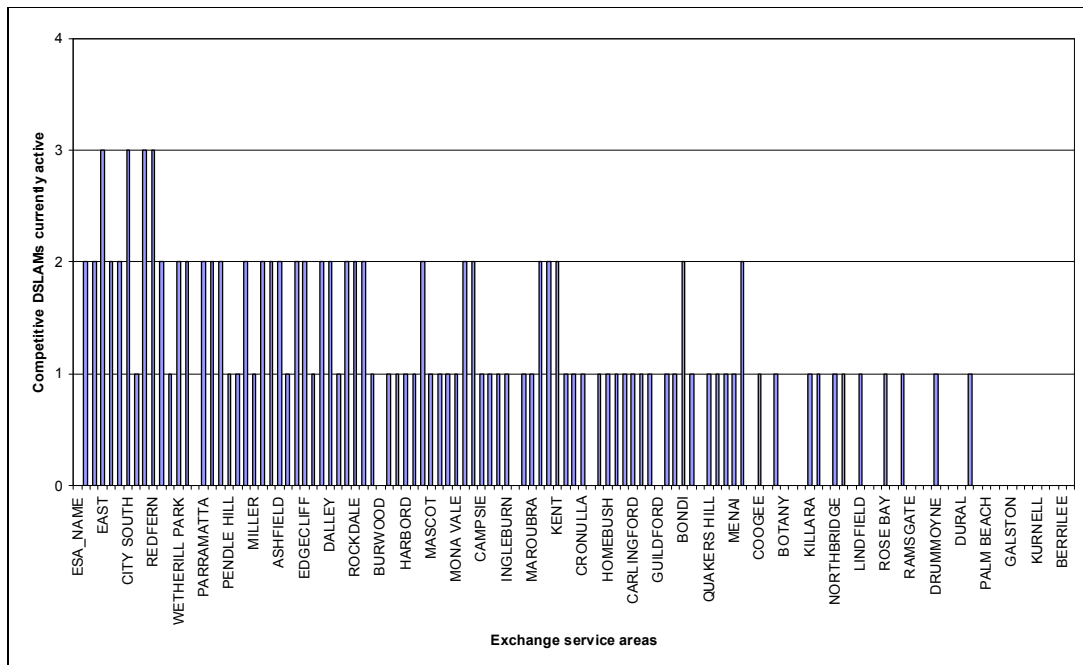
Table 4. Current and planned competitive DSLAM deployment, by State and Territory

	Currently Active	Planned	Total
NSW	134	227	361
Victoria	61	227	288
Queensland	42	157	199
SA	60	87	147
WA	100	79	179
Tasmania	1	17	18
NT	1		1
<i>Total</i>	399	794	1193

Sources: Company websites. Optus geographic rollout estimated, based on most likely 350 exchange service areas by services in operation.

50. Within each metropolitan area, the geographic coverage of competitive DSLAMs is already broad, and will become broader as competitors complete their stated rollouts. Figure 3 shows the current active competitive DSLAMs in the Sydney metropolitan area. Exchange service areas have been grouped by services in operation, with the most densely populated ESA (North Sydney) to the left of the chart.

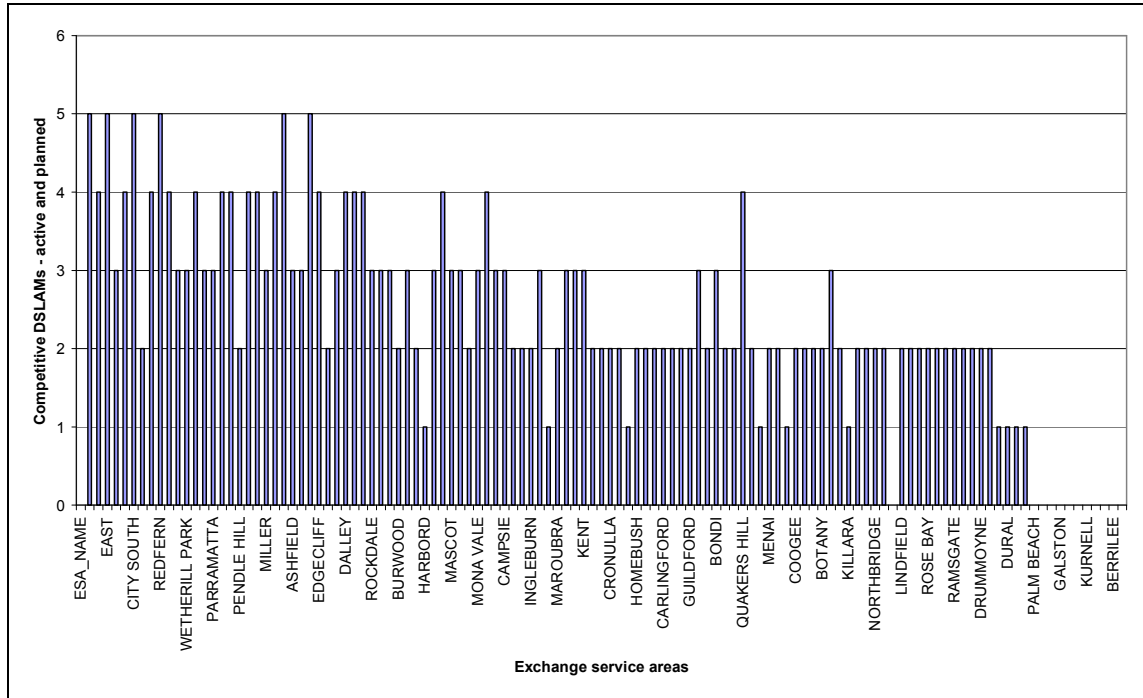
Figure 3. Current active competitive DSLAMs per ESA in the Sydney metropolitan area



51. Not surprisingly, current competitive DSLAM rollout is most prevalent in the more highly populated ESAs. The great majority of ESAs already have at least one competitive DSLAM, and many ESAs have two competitive DSLAMs.

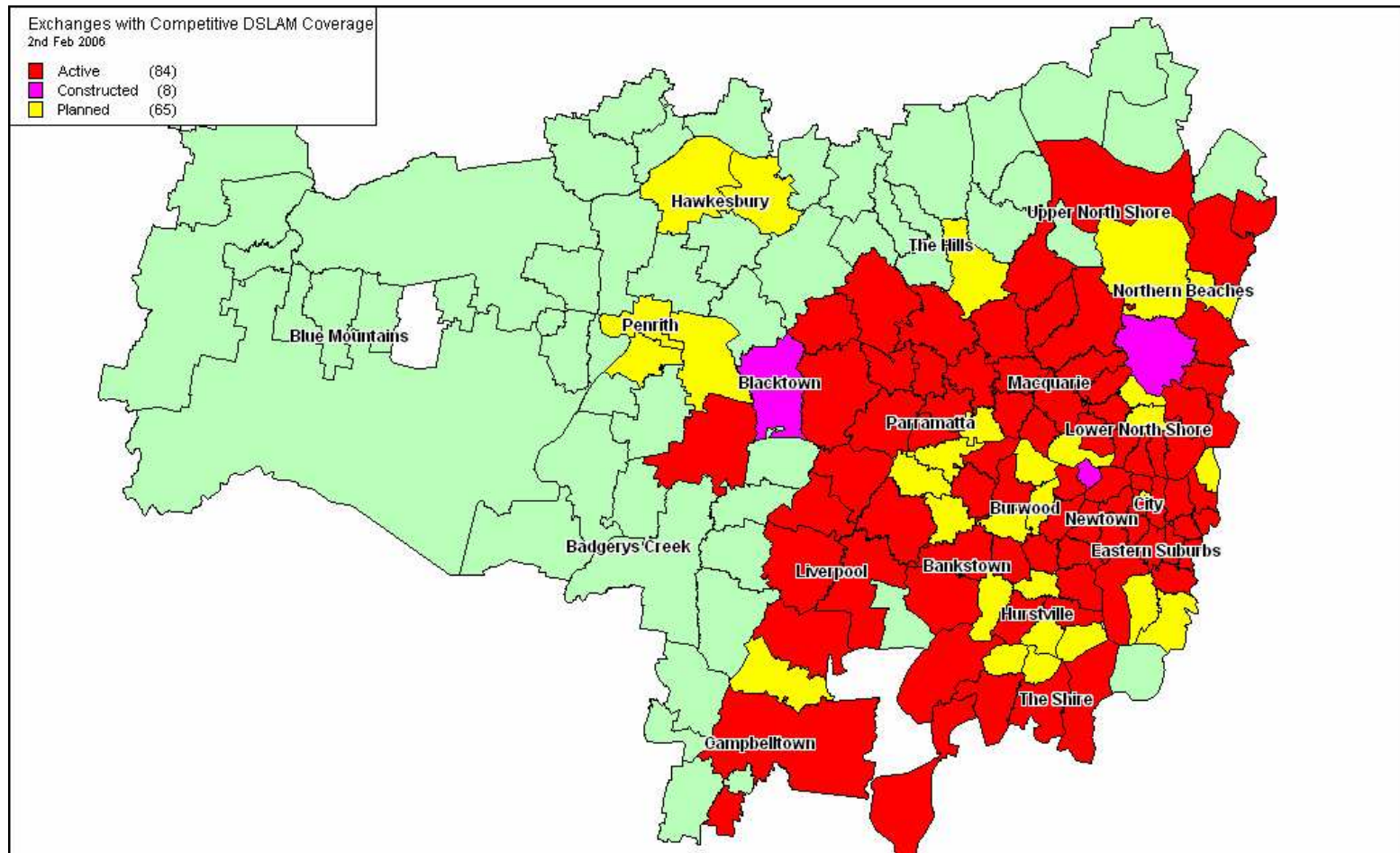
52. Figure 4 shows both the current and planned competitive DSLAM rollout in the Sydney metropolitan area.

Figure 4. Active and planned competitive DSLAMs per ESA in the Sydney metropolitan area



53. When currently active and planned DSLAMs are mapped, it is clear that the great majority of ESAs will have at least two competitive DSLAMs. Many ESAs will have three, four and even five competitive DSLAMs. Figure 5 maps this information.

Figure 5: Sydney competitive DSLAMs mapped



Source: Competitor websites as at February 2006. Optus rollout estimated.

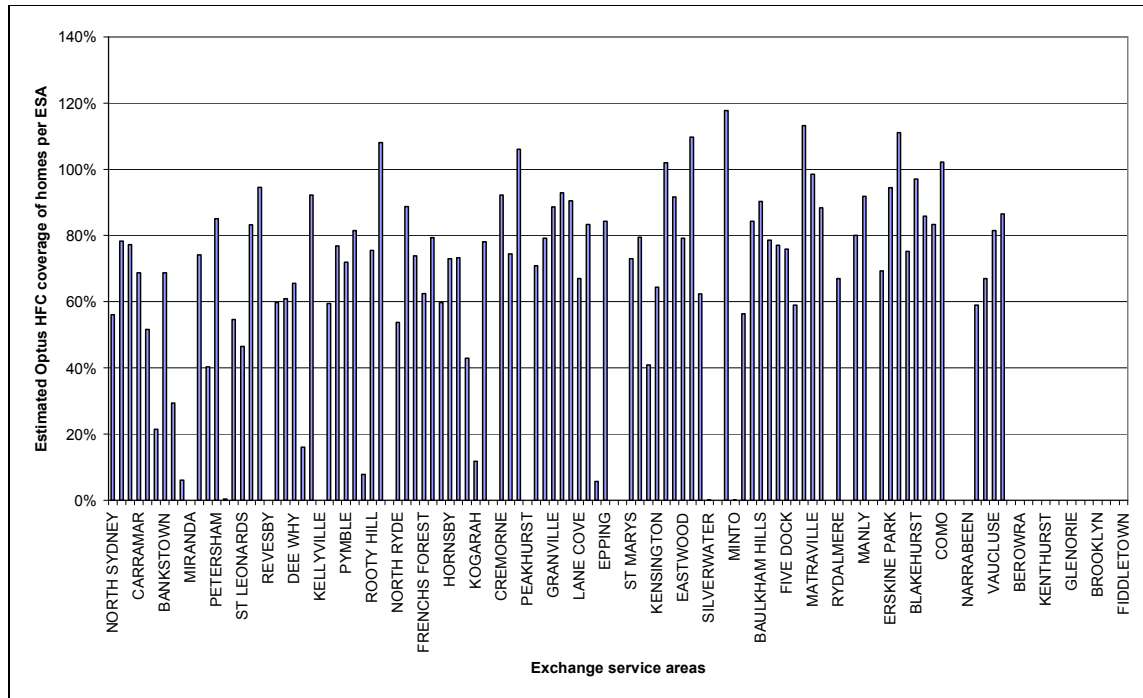
54. Clearly Sydney is the most developed market for competitor DSLAM rollout, but other metropolitan areas are not far behind. As previously discussed, Telstra believes the Commission is best placed to conduct a more exhaustive audit of competitive infrastructure, and offers this information as indicative only.

A.2 Optus HFC Rollout

55. As mentioned previously, the Commission needs to build a picture of all competitive infrastructure which constrains Telstra. Aside from examining the extensive build of competitor DSLAM infrastructure, the Commission must also be cognisant of other competitor networks. In this section Telstra provides evidence of the extent and coverage of the Optus HFC network. Other networks the Commission should examine are the Transact cable network in Canberra and the Unwired Wireless network.
56. Optus' HFC network, which covers large parts of the Sydney, Melbourne and Brisbane metropolitan areas, is clearly a major competing network.
57. Telstra does not have access to Optus' HFC rollout on an ESA basis. Unlike DSLAMs which map to each ESA, Optus' HFC rollout is independent of the ESA configuration of Telstra's network. However, Telstra has estimated the likely percentage of homes passed by Optus' HFC in the following manner to assist the Commission's understanding of the prevalence of infrastructure based competition:
- A) ESAs have been grouped by SIOs.
 - B) We have then estimated the number of homes in each ESA by dividing the number of SIOs by 1.2.
 - C) We then collated the homes passed by Telstra's HFC in each ESA. This number was used as a proxy for the number of homes passed by the Optus HFC. Telstra understands there is a high degree of over build between the two networks, so this assumption should not skew the analysis.
 - D) Finally, we divided C) by B) to obtain an estimate of the percentage of homes served by the Optus HFC in each ESA.

58. Telstra has again focussed on the Sydney metropolitan area for illustrative purposes only. The results of this analysis are shown in Figure 6. Telstra has again shown ESAs from highest to lowest SIOs.

Figure 6. Estimate of Optus HFC coverage in each exchange service area of Sydney metropolitan area

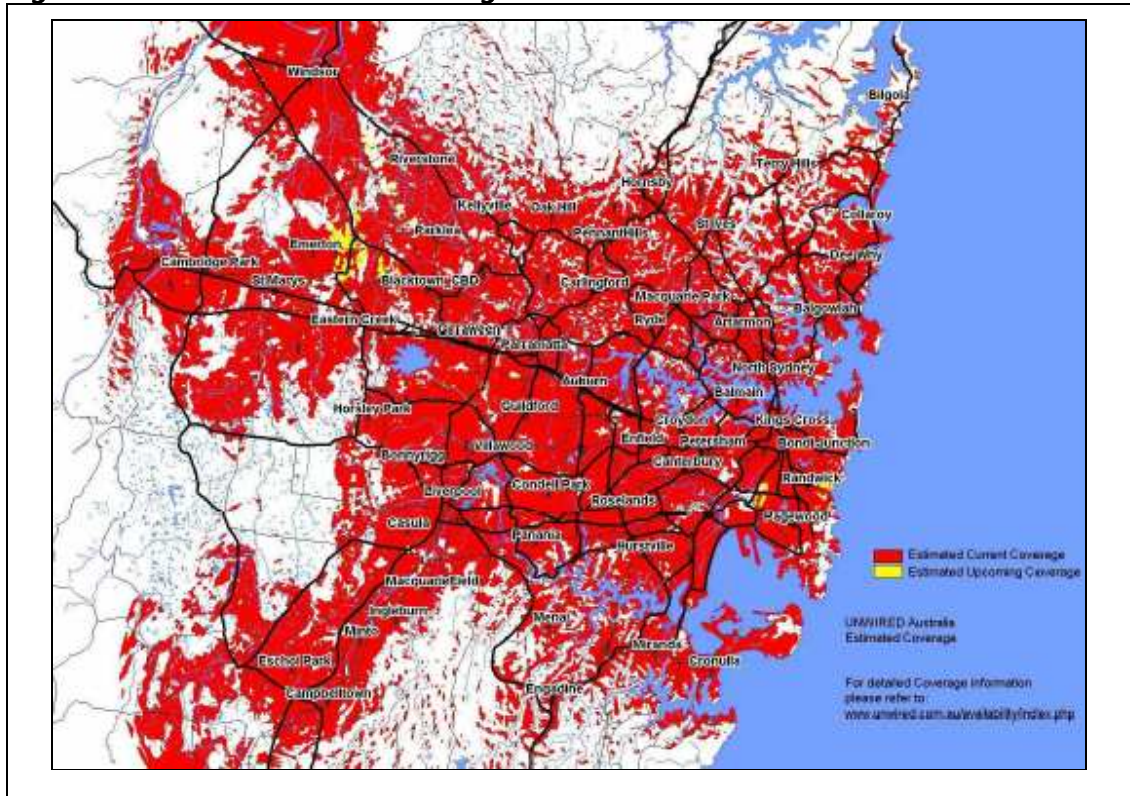


Note: due to the use of an average of 1.2 SIOs per home, some ESAs appear to have greater where Optus HFC is estimated to exceed 100

59. The Commission clearly needs to overlay this HFC rollout with the competitive DSLAM rollout to begin to understand the competitive pressure Telstra is subject to in the Sydney metropolitan area. Clearly, to get a more complete picture, the Commission would then need to overlay the mobile networks, and Unwired's network. Telstra has included Unwired's Sydney coverage in Figure 7 to assist. Note that Unwired has announced an expansion to Melbourne, and will be targeting inner Melbourne initially.⁸

⁸ Unwired recently announced that from 5 April its network will cover all or part of the following suburbs: Melbourne CBD (South, West and East), Port Melbourne, Albert Park, Carlton (North and South), South Yarra, Bentleigh, Ormond, McKinnon, Patterson, Richmond (East, West and South), Hawthorn, St Kilda, Docklands, Toorak, Fitzroy, Middle Park (Unwired press release, 3 April, 2006)

Figure 7. Unwired network coverage



Note: Taken from slide 4 of Unwired's presentation to the Linux.Conf.Au conference in January 2006.

60. If the Commission were to conduct this analysis, it is unclear to Telstra how it could be satisfied that declaration of LCS and WLR is in the LTIE. The Commission's continued promotion of resale based competition in the face of such extensive infrastructure based competition is puzzling at best, and contrary to the objectives of Part XIC of the Act.

Appendix B Wholesale line rental service

61. Telstra does not believe that declaration of WLR is necessary or has been shown by the Commission to be in the LTIE.
62. However, if the Commission is minded to proceed with declaration in accordance with its draft decision, it is important that the service description it chooses adheres to the following principles:
 - the service description should be as narrow as practicable
 - the service description should be carrier independent
 - the description should not include value added services, such as Telstra Home Messages 101™.
63. Telstra broadly agrees with the draft service description presented by the Commission in Appendix D of the draft report. Telstra has suggested only a minor change to this description to ensure that the phrase 'certain types of calls' is limited to voice call services delivered over the PSTN (specifically 'calls transmitted at 3.1khz bandwidth').
64. The service description, amended so as to specify 'certain types of calls' is presented in section B.2.
65. Any declaration needs to be designed to minimise the associated costs. This can be achieved by the service description mirroring the definition of the basic access service that Telstra already supplies, which has been accepted by industry for many years and with which people are familiar.
66. Telstra submits that if the Commission determines to separately declare WLR, the service description should not specify the inclusion of add-on services, such as Telstra Home Messages 101™.
67. These add-on services are not an essential characteristic of basic access and do not represent a bottleneck that requires regulatory intervention. They can already be provided by competitors using their own infrastructure and/or services. Additionally, if the Commission is of the opinion that WLR is less likely to be provided with other services, such as the LCS, in the future, then it would be quite inconsistent to define the declared WLR service to include add-on features which are related to the provision of voice services.

68. It is therefore not in the LTIE to declare access to these add-on features, as there is no compelling benefit in doing so and it would be costly to achieve — requiring changes to systems and processes — and would have the potential to create needless uncertainty in the market as to precisely which services were included or excluded from the declared service.

B.1 Proposed line rental service description

Although Telstra believes that declaration of a WLR service is not in the LTIE and should not proceed, Telstra proposes the following definition of a declared WLR service in the event that the Commission does not declare the service:

“

The line rental service is a line rental telephone service which allows an end-user to connect to a carrier or carriage service provider’s public switched telephone network, and provides the end-user with:

- A. an ability to make and receive any 3.1khz bandwidth calls (subject to any conditions that might apply to particular types of calls) made over the public switched telephone network. These calls may include, for example, local calls, national and international long distance calls etc
- B. a telephone number

Definitions

Where words or phrases used in this declaration are defined in the Trade Practices Act 1974 or the Telecommunications Act 1997, they have the same meaning given in the relevant Act.

In this Appendix:

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies.

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Appendix C Appropriate pricing of declared services

69. For the pricing of LCS to be consistent with the legislative criteria, it is Telstra's view that the pricing must be consistent with two principles:
 - a. full cost recovery and no more; and
 - b. competitive neutrality.
70. Full cost recovery ensures that the access provider is able to recover the full efficient costs of supplying services supplied over the PSTN. Full cost recovery is critical to promoting efficient competition between Telstra, access seekers and other facilities-based competitors and a requirement for ensuring that the incentives exist for efficient investment in the PSTN.
71. If the prices for PSTN services, including LCS, are set below the level that allows efficient cost recovery then access seekers will be provided with an artificial advantage over Telstra and other facilities-based competitors. They will be permitted to compete in the provision of PSTN services, even if they are less efficient than alternative suppliers. In Telstra's view, encouraging competition on the basis of below-cost access prices is inconsistent with the objectives of the legislation, as it promotes inefficient entry and artificially disadvantages facilities-based competitors that do face the full network costs of providing services. In Telstra's view, the objective of the legislation is to promote efficient competition, which means encouraging competition on the merits so that only the most efficient suppliers are able to successfully compete. In turn, efficient competition is in the LTIE, as end-users benefit from real efficiency gains over the long-run rather than short-term price reductions that are delivered via below-cost access prices, which are clearly unsustainable over the long-run.
72. Full cost recovery is also a requirement for achieving efficient investment in the PSTN. To ensure that investment in the PSTN in Australia continues, investors must have an expectation that the costs of building and maintaining the PSTN will be recovered from prices paid for services that are provided over the PSTN. This is not limited to efficient investment by Telstra in its own PSTN, but extends to ensuring that the appropriate signals exist for investment in alternative PSTN or substitute infrastructure. If access seekers are not provided with the correct build/buy signals then efficient investment will not occur. In particular, if access prices simply allow access seekers to use Telstra's PSTN below the efficient cost

of provision then access seekers will have no incentive to invest in alternative infrastructure, even when it is more efficient.

73. In Telstra's view, the objectives of the legislative criteria can only be met if competitive neutrality is maintained between Telstra and access seekers. Long run competitive neutrality requires that:
- equally efficient firms have the same opportunity to recover their total costs; and
 - equally efficient access seekers and access providers are neither advantaged nor disadvantaged in their respective roles in making market entry/exit and investment decisions⁹.
74. For LCS this means that prices should be set by ensuring that the same level of costs is allocated to wholesale and retail services. To do otherwise would mean that the access provider and access seeker would face different input costs in the supply of retail local call services. Such an outcome would be inconsistent with the legislative criteria, as it would allow inefficient entry and would distort efficient investment decisions.
75. It would allow inefficient entry, as access seekers would face lower costs than efficient access providers, allowing them to successfully supply services, even if their retail costs are inefficiently high. It would distort efficient investment decisions because the access provider would face higher input costs than access seekers for the supply of retail local calls. This would allow the access seeker to undercut the access provider in the retail market, preventing the access provider from recouping the efficient costs of its investment.
76. Telstra believes that the LCS price proposed in its recent Undertaking is consistent with both principles and hence with the legislative criteria. While Telstra has set the individual price point for LCS using a Retail Minus Retail Cost ("RMRC") approach, full cost recovery is ensured by setting PSTN OTA prices at a level that allows full cost recovery across the full range of services that use the IEN component of the PSTN. Further, Telstra's recent increase in the wholesale basic access price allows Telstra to fully recover the efficient costs of the CAN component of the PSTN.

⁹ See, Tye W. 2002, *Competitive Neutrality: Regulated Interconnection disputes in the Transition to Competition*, paper for ACCC Regulation and Competition Conference, July 25-26.

77. In addition and as Telstra demonstrated in the supporting submission to its Undertaking, the proposed price for LCS is set on a competitively neutral basis. That is, every local call that uses the PSTN is allocated exactly the same level of costs, regardless of whether it is a retail local call or a wholesale local call.
78. Therefore, Telstra believes its proposed prices for LCS of 9.28 cents per call and its prices for wholesale basic access of \$31.77 for business lines and \$26.70 for residential lines are reasonable with respect to the legislative criteria.
79. The remainder of this section responds to the issues raised by the Commission in its Draft Report.

C.1 Relativity between costs and retail prices

80. The Commission makes the following comments with respect to the costs associated with LCS:
 - appropriately defined TSLRIC+ costs of providing local calls and line rental are likely to have declined significantly in recent periods, and may now be below the access prices set under the current pricing approach;
 - it is likely that adjusted PIE II estimates for the period are likely to either eliminate the gap or potentially result in Telstra earning positive margins on access prices for these services;
 - while it is difficult to be definitive at this stage as to the estimates which would be produced by a robust and independent alternative cost model, the ACCC reasonably expects that the estimates produced would likely result in TSLRIC+ estimates being below access prices set under the current approach.
81. Telstra does not understand on what basis the Commission could have come to any of the above conclusions given its past estimates of PSTN costs and given that it has not undertaken any further analysis of its own. Given the lack of any evidence to support the Commission's conclusions and the Commission's predetermined conclusions on the results Telstra has serious concerns about the level of independence with which the proposed cost modelling exercise will be conducted.

82. First, it is unclear on what basis the Commission could assume that the level of TSLRIC+ costs for providing local calls and line rental have declined significantly.
83. Based on the only available estimates that the Commission has produced for line rental costs, these costs are increasing over time. In its 2000 Assessment of Telstra's Undertaking for Domestic PSTN Originating and Terminating Access Services, the Commission reported that efficient line costs for 1999-00 were \$336 per year and for 2000-01 were \$346 per year, an annual increase of 3%. Unless the Commission has now decided that its previous estimates were incorrect (and Telstra notes these figures were already substantially below what NERA concluded were the appropriate efficient line costs) or that labour costs, which drive CAN costs, are now declining instead of increasing, then an extrapolation of the Commission's own estimates would result in a line cost of \$425 per year (\$35 per month) in 2006/07.
84. While the Commission later argues that Telstra receives contributions toward CAN costs from industry and Government subsidies and potentially from services such as xDSL, the Commission fails to elaborate as to what subsidies it is referring and why it believes that xDSL makes any contribution to CAN costs. It is correct that Telstra receives a very small contribution toward CAN costs (including Telstra's own contributions) from the USO, which across all basic access services amounts to less than \$1 per month per service. In terms of other Government subsidies, the Commission may be referring to the ADSL scheme run by the Government, although this is unclear. However, Telstra notes that if these subsidies are to be treated as a contribution toward CAN costs for the purposes of calculating line rental prices, then no wholesale ADSL access seeker or ULLS access seeker could be eligible for these subsidies, they would only be available to suppliers that provided CAN services. Telstra does not believe that this is the way that the Government intends for these subsidies to be implemented. In terms of contributions from the provision of xDSL services, the Commission provides no evidence in support of this claim and would need to demonstrate that Telstra's xDSL prices are set in excess of xDSL specific costs.
85. In terms of IEN costs, the Commission itself has noted that the IEN cost pool is extremely insensitive with respect to traffic volumes. The Commission should also be well aware of the substantial decline in PSTN traffic volumes. The combination of these two factors, has resulted in substantial increases in unit

costs of PSTN traffic, including local calls. Therefore, it is difficult to understand the Commission's conclusion that LCS costs will decline significantly.

86. Second, the Commission again notes its concerns about the PIE II model and claims that its adjustments to the PIE II model would eliminate any remaining gap between costs and prices and could potentially result in Telstra earning a positive margin. Telstra is well aware of the Commission's issues with the PIE II model and has provided all the information and evidence it believes is necessary to support the PIE II model. However, given the Commission's reservations about PIE II, Telstra also provided other supporting material in its supporting submission to the PSTN OTA and LCS Undertaking to demonstrate the reasonableness of the PIE II results. Telstra presented historic and current cost estimates, prepared in accordance with the Commission's own record keeping rules and presented extrapolated results from the Commission's own TSLRIC estimates. All of these figures were higher than the c-i-c of IEN costs that Telstra is seeking to recover across all PSTN services, of which Telstra is seeking just 10% from access seekers in the form of LCS charges. Therefore, it is unclear to Telstra on what basis the Commission claims that the level of costs estimated in the PIE II model is unreasonable.
87. Third, the Commission states that it expects that the results of its cost modelling exercise will result in access prices below prices set on the basis of RMRC. Telstra is extremely concerned that the Commission has predetermined views on the results of what it suggests will be a "robust and independent" modelling exercise, particularly given that there is no evidence to suggest that the TSLRIC+ of either local calls or line rental have declined, but rather the opposite.

C.2 Reasonableness of alternative pricing principles under s152AH

88. Telstra strongly disagrees with the Commission's assessment of the promotion of competition. The Commission concludes that where costs are above retail prices, an RMRC approach is likely to promote competition. As noted above, access prices should be set to allow full recovery of efficient costs. If the Commission has a particular issue with the level of access prices for LCS, then it should allocate less costs to LCS and more to other services to ensure full cost recovery is not compromised. It is not appropriate, as the Commission has done

in the past, to set LCS prices in isolation at RMRC and then allocate excessive costs to LCS in its TSLRIC study in order to provide access seekers with low prices for PSTN OTA.

89. Telstra does not believe that there is any difficulty with LCS prices being set at cost, because it believes that the relevant market, at a minimum, is the fixed telephony market. Therefore, access seekers will recoup their costs across the total bundle of PSTN services and it does not matter if the price for one component is high, as long as full cost recovery is being achieved on a competitively neutral basis and access seekers can make a margin across the full bundle of PSTN services.
90. If the Commission believes that the market is narrower (and Telstra notes that it is not at all clear from the market definition section of the Commission's paper, what the Commission's product market definition is supposed to be) then the Commission should not compromise the cost recovery principle, but simply allocate costs in a different way – ie reduce the costs allocated to local services where margins are low and increase costs allocated to PSTN OTA where margins are high.
91. The Commission also appears to argue regarding cross-subsidies from other sources, which is confused. Telstra made the point in an earlier submission that if the cost of local calls is in excess of what can be charged for those calls then access seekers should be put in the same position as Telstra. That is, Telstra recovers the costs of its PSTN services across the full bundle of PSTN services and there is no reason why access seekers should not have to do the same. Telstra also notes that in reality, it is simply a cost allocation issue. In the past, the Commission has allocated common costs to local calls in a way that results in local call costs exceeding the local call retail price. There is no reason why such a cost allocation approach should be maintained and indeed Telstra's current Undertaking reduces the level of costs allocated to local calls with a corresponding increase in the level of costs allocated to PSTN OTA.
92. As noted above, if the Commission believes it is necessary for a positive margin to exist on local services alone, then it should reduce the level of costs allocated to local services and increase the level of costs allocated to PSTN OTA. In other words, the Commission's issue can be simply addressed by adopting a more appropriate cost allocation methodology, without compromising the objective of full cost recovery.

93. With respect to the other criteria, the Commission appears to assume that RMRC and cost recovery are alternatives and hence seem to weigh up the benefits and difficulties with both approaches. In Telstra's view, the principles can be reconciled, and in Telstra's current Undertaking are consistent. RMRC is used to set the price for the individual LCS service, while cost recovery is still achieved by setting PSTN OTA prices to recover the remaining IEN costs of the PSTN. Given that local call services and other PSTN services share exactly the same infrastructure, the prices for these services cannot be set in isolation. The level of common costs allocated to local calls and LCS needs to be informed by the regulatory restrictions on cost recovery (ie retail price controls), and the level of common costs allocated to other services should be consistent with the legislative criteria, which require full recovery of efficient costs. In Telstra's view, so long as full cost recovery is achieved on a competitively neutral basis across all services that use the PSTN, RMRC can be used to set the price for LCS without compromising any elements of the LTIE.

C.3 Implementation issues

Avoidable or avoided costs

94. With respect to avoided versus avoidable costs, Telstra remains of the view that the avoidable cost approach remains the theoretically correct approach to the implementation of RMRC. However, Telstra also notes that whatever methodology is used to set the price of LCS, full cost recovery across all PSTN services should not be compromised. Therefore, whether avoided or avoidable costs are used in the calculation of RMRC is not particularly important so long as the efficient network costs not recovered from LCS and local calls is recovered on a competitively neutral basis from other services. For this reason, Telstra adopted the Commission's average cost approach in determining the LCS price in the current Undertaking. 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.

Benchmark retail price

95. Telstra agrees with the Commission that the unbundled price is the most appropriate starting price for the RMRC calculation. However, it disagrees with

the Commission's concerns regarding negative margins on local call services. The market is, at a minimum, a market for fixed telephony services and hence a negative margin on any individual services within the bundle is irrelevant for the assessment of competition. Rather, it is the margin across the full bundle of fixed telephony services that is of interest, and this margin has always been positive, even based on the Commission's conservative Accounting Separation rules.

Joint or Independent Pricing

96. Telstra has set its LCS prices on the basis of what industry has preferred. Specifically, that is to purchase line rental at the full retail price and deduct the retail costs for the line rental service from local calls. Telstra departed from this approach when it increased the wholesale basic access price in December 2005. Telstra only increased the wholesale basic access price to \$27.60 (GST exclusive) rather than the full retail price of \$29.05 (GST exclusive price of HomeLine Part). However, Telstra did deduct the full average retail costs for both the line rental product and the local call product from the local call price to arrive at the LCS price of 9.28 cents per call. Therefore, Telstra's pricing for LCS and WLR access are actually below the level that would result from application of the Commission's pricing principles.
97. If the Commission were to force Telstra to depart from this structure of pricing then it would have implications for the current Undertaking. If the Commission required Telstra to deduct only the retail cost of local calls from local calls then the resulting prices would be 17.69 cents per LCS call. While the line rental price would be lower, approximately \$23.60, this would prevent Telstra from fully recovering CAN costs and Telstra would need to reintroduce CAN costs into the calculation of PSTN OTA prices.
98. Telstra could not offer both options, as it would open arbitrage opportunities. For example, one access seeker could purchase LCS at the rate of 9.28 cents per call from Telstra and resell these calls to another access provider (at any price below 17.69 cents) who has purchased the stand-alone line rental product at \$23.60. Therefore, the retail discount for the line rental product would be provided twice.
99. Accordingly, it is Telstra's view that where an access seeker purchases the bundle of line rental and local calls, the RMRC methodology should apply with

the retail costs for local calls being deducted from local calls. If line rental is declared and an access seeker wishes to purchase line rental as a stand-alone service for the reasons suggested in the Commission's paper then the price should reflect the TSLRIC of providing the service.