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"By Email"

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Dear Mr Riordan,

Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services – Discussion Paper December 2009

Background

TransACT is pleased to submit a response to the Australian Competition & Consumer Commission (ACCC) 'Discussion Paper' on the *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services,* released by the Commission on 3 December 2009.

As the Commission would appreciate, there has been a considerable amount of time and effort placed in the ongoing review of fixed line services in Australia, including initiatives undertaken by the Commission such as:

- the commissioning of the Analysys cost model;
- the ACCC 'Specific Costs' cost model;
- international benchmarking; and
- the analysis of the Telstra Efficient Access (TEA) model.

In October 2009, the ACCC received several submissions to their *Draft Pricing Principles and Indicative Prices for LCS, WLR, PSTN OA, ULLS and LSS* Consultation Paper, in which TransACT provided a response.[1] Most recently, in December 2009, the ACCC released Final Pricing Principles and Indicative Prices for the period 1 August 2009 to 31 December 2010.

The ACCC considered that rolling over 2008-09 pricing principles and indicative prices would provide certainty regarding access to regulated services in a period of potential legislative change and would achieve the objective of promoting the long-

[1] TransAct submission on draft pricing principles & indicative prices 9 October 2009.pdf

term interests of end-users (LTIE). The ACCC noted, as part of this review, that the Australian Government (the Government) proposed reforms to the telecommunications competition and consumer framework, particularly in relation to the National Broadband Network (NBN), would have a major impact on the future regulatory environment including the regulation of the fixed services. TransACT agrees with this view and believes that the uncertainties associated with the NBN and associated regulatory reforms has, to an extent, stifled industry confidence and investment.

Whilst TransACT agrees that rolling over 2008-09 pricing principles and indicative prices, may have been the most appropriate and less disruptive for the industry at the time, It will be important that the Commission not only provides regulatory certainty during the transition period to a NBN, but ensures that final access pricing principle determinations for fixed line services, during that transition period, continues to promote industry investment, competition and the long-term interests of end-users.

Although it may be difficult for the ACCC to speculate on potential NBN outcomes, in reviewing access pricing principles for fixed-line services, it will need to cognisant of those outcomes when framing its pricing principles and be able to react accordingly.

Frontier Economics analysis

As a member of the Competitive Carriers Coalition (CCC), TransACT supports in principle the Frontier Economics (FE) response to the ACCC's discussion paper prepared for the CCC.[2]

Some of the key messages and conclusions from the FE response are as follows:

1. **Ensuring that the most appropriate starting point for determining access prices for fixed-line regulated services is to use cost based pricing principles.**

   In the ACCC discussion paper the following cost based methods are outlined:

   - Historic cost / actual cost;
   - Depreciated historic / actual cost (DHC/DAC);
   - Optimised replacement cost (ORC);
   - Current replacement cost; and
   - Depreciated optimised replacement cost (DORC).

   TransACT believes that a cost-based pricing principle is the most appropriate.

2. **TSLRIC is still, in general, the appropriate cost concept for pricing fixed-line telecommunications access services. But the way it is measured can be improved.**

[2] Frontier economics – Access pricing principles for fixed line services, a response to the ACCC's discussion paper prepared for the CCC.

In TransACT's previous response to the ACCC, in October 2009, on *Draft Pricing Principles and Indicative Prices for LCS, WLR, PSTN OA, ULLS and LSS,* while TransACT accepted that using the total service long-run incremental cost (TSLRIC) model was appropriate, we believe it is the concept of that model that is appropriate, but not necessarily utilising forward looking costs.

We further stated that there are many variants of cost-based pricing, of which TSLRIC is one, all of which are ultimately dependant on the inputs to the associated model and how they are applied, allocated and measured. Additionally, it may also be appropriate to apply international benchmarking, the Analysys model and the ACCC's Specific Costs' cost model.

It is also important that with the impending NBN and current regulatory reform, that consideration of pricing principles and indicative prices for fixed line services occurs in that context.

3. **When measuring TSLRIC, it is sensible to construct and "lock-in" an initial RAB rather than have periodic revaluations of relevant asset bases.**

TransACT agrees with this approach.

As summarised by FE, the costs of ongoing revaluations are highly likely to exceed their benefits. Revaluations create uncertainty and ongoing regulatory proceedings (affecting not just Telstra, but also access seekers) and, if replacement costs continue to rise and this rise is sufficient to offset any optimisations, it allows for Telstra to earn monopoly returns. Revaluations could be beneficial if they sent useful signals to investors or users, but in the current context the primary impact of revaluing assets is changing the distribution of value between Telstra and access seekers.

4. **Setting an opening value for the RAB requires a difficult exercise of regulatory discretion, and a balancing of interests. No one valuation approach is superior in meeting all regulatory objectives, and all approaches will be difficult and contentious to implement.**

Although many approaches may be considered TransACT believes the fairness and benefits associated with setting an open value for the regulatory asset base (RAB) are best applied using a modified approach to DHC. This is further explored in the FE response paper. The application of ORC, DORC or current replacement cost are all highly contentious and have implementation issues in setting an opening value for RAB, which are neither efficient or effective. When setting an opening value for RAB it should not be re-valued as it creates further uncertainty, as stated above.

5. **We favour setting the opening RAB based on the gross value of historic costs (from Telstra's regulatory accounts) and deducting the accumulated depreciation based on actual levels of cost recovery.**

TransACT agrees with FE that in setting an opening RAB an adjusted form of DHC should be used, where the gross value of historic costs from Telstra's regulatory accounts is reduced by the actual compensation that Telstra has been provided against those assets to date.

6. **If such an approach is too difficult to implement, then consideration should be given to adopting the depreciated asset values in Telstra's accounts.**

   TransACT supports this approach.

7. **Rather than an overriding price constraint across all services, a CPI-X expenditure incentive mechanism should be applied to prices at least down to the level of each access service. The service specific X-factors should be set by the regulator.**

   TransACT supports this approach.

8. **A service quality incentives mechanism that contains financial rewards and penalties is also required.**

   TransACT supports this approach.

   As stated by Burns and Riechmann (2004, p. 218):

   > *Regulation needs to acknowledge quality of services as a key output of infrastructure providers and good quality performance should be rewarded financially. Quality rewards should be designed such that infrastructure providers have incentives to select the efficient level of investment.*

   Such a mechanism would provide a strong signal to focus on quality and performance.

9. **As long as Telstra is a vertically-integrated provider of fixed-line access services, it should not have the freedom to allocate common costs between different regulated services as it sees fit.**

   TransACT supports this approach.

   A vertically integrated Telstra should allow for the introduction of a quality mechanism to encapsulate measures that cover equivalence of performance with self-provided services. Building indicators based on Standard Access Obligations (SAO's) into a quality incentive mechanism could reduce reliance on Part XIB mechanisms such as Record Keeping Rules (RKRs) to monitor and enforce them.

In moving to a fixed RAB framework there should be a governance process to ensure that only efficient levels of expenditure are incurred over time and that service quality is maintained. A well designed incentive scheme should assist in this process as well as addressing equivalence of access while Telstra remains vertically integrated.

The over-arching structure of the FE report for determining an appropriate price for regulated access services, in which TransACT supports, is to address:

- The costs Telstra should be allowed to recover in access prices to compensate it for capital investments it makes in the infrastructure used to provide the declared services. This is heavily influenced by decisions on how to value assets, incorporate depreciation and 'roll-in' future capital investments into a RAB.
- How Telstra can be given incentives to minimise its costs and to maintain service quality over time.
- The level of flexibility and discretion that should be given to Telstra to allocate costs across the various fixed-line access services when setting access prices for each of these services.

This is an important structure to consider as part a fixed line services review when considering a RAB framework.

Conclusion

In an effective wholesale market, there should be no need for retail price control arrangements that protect consumer prices. An effective wholesale market is one that provides equivalence of access, on both price and non-price terms, where access prices should only cover the directly attributable costs of providing the service. TransACT believes that the concept of TSLRIC, but not necessarily utilising forward looking costs, would seek to ensure this is the case.

This concept is reasonably well accepted, but for many years has not been appropriately addressed. The announcement by the Government to invest up to $43 billion over eight years to build and operate a "wholesale only" company is testament to the fact that the regulatory regime has previously failed.

With the impending NBN and the recent legislative announcements made by the Government, culminating in the current Competition and Consumer Safeguards (CCS) Bill 2009 before Parliament and the draft legislation released this week for NBN Co operations[3], it is important that consideration of pricing principles and indicative prices for fixed line services occurs in that context.

Finally, regardless of the model/s adopted by the ACCC consideration needs to be given for transitional arrangements to ensure that potential price shocks do not unduly impact on the industry or the LTIE. TransACT previously addressed the issue of 'price shocks' and appropriate 'glide paths' in its previous submission to the ACCC's *Draft Pricing Principles and Indicative Prices for LCS, WLR, PSTN OA, ULLS and LSS* Consultation Paper. While TransACT is not suggesting a methodology in this response, TransACT still maintains that an appropriate 'glide path' that minimises 'price shock' is required.

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[3] http://www.dbcde.gov.au/broadband/national_broadband_network/nbn_company_legislation_and_access_regime

Please do not hesitate to contact me should you have any queries on this submission.

Yours sincerely

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