



**Response to the Government Discussion Paper:
*National Broadband Network: Regulatory Reform for
21st Century Broadband***

June 2009

Introduction and Background

The CCC welcomes the opportunity to respond to the Government's discussion paper, *National Broadband Network: Regulatory Reform for 21st Century Broadband*.

The CCC has consistently argued the need for fundamental reform of the regulatory arrangements supporting competition in Australian communications. The announcement of the NBN policy by the Government adds to the importance of strong and effective reform.

The CCC submits that the title of the discussion paper underlines the goals that must guide the reforms proposed by the Government to the regulatory arrangements.

The regulatory regime needs to perform three tasks over the next five-eight years:

- Put in place a regulatory regime capable of creating and support world-best competition on the existing network (keeping in mind that it will be the basis of communications services availability for most Australians for up to eight years);
- Stimulate rapid growth in retail telecommunications competition to prepare both the industry and consumers to take advantage of the opportunities created by an NBN access network, in particular the proposed FTTH component, and;
- Allow consumers and retailers to move seamlessly onto the new platforms to the greatest extent possible.

The Importance of Competition on the Existing Network and the Risks to Success

Looking forward to the NBN can give policy makers some comfort that the industry structure in the future will be conducive to robust and dynamic competition. However, this must not result in the intervening eight years cannot be wasted.

The lamentable relative performance of Australia across communications markets – especially broadband – compared to the rest of the OECD since 2001 illustrates the potential lost opportunity if the regulatory changes proposed for this year are not as effective as they might be.

All aspects of the regulatory arrangements to be introduced this year must be compatible with the post-NBN arrangements to the greatest extent possible. It is

inevitable that there will be some disruption to the whole industry as the transition to the NBN occurs.

These adjustments will need to be made in response to changes in two domains: the regulatory structure within which the post-NBN industry operates, and the technical changes required as service providers move to begin delivering services over the new NBN platforms and off the legacy copper network.

If all of these changes occur together, there are increased chances of unnecessary dislocation within the industry and to the delivery of important consumer services.

On the other hand, this disruption can be mitigated by making the regulatory changes as early as possible and allowing them to bed in. This will make the technical transition to the NBN smoother, and therefore the take up of the NBN opportunity by retailers and consumers alike should be more enthusiastic. This, in turn, will have important implications for the financial viability of the NBN.

Therefore, more decisive action to address necessary regulatory changes this year will lead both to a greater chance that the endemic problems of today will finally be resolved, and an easier transition to the future NBN-based regulatory world later. The Government's discussion paper recognizes that it is important that the regulatory changes to be introduced this year are compatible with the NBN environment.

Further, it must be recognized that there is an incentive for Telstra, all things being equal, to ramp up its efforts to disrupt competition through the period leading up to the switching on of the NBN. Telstra's vertical market power will be dramatically diluted, if not eliminated, by the transition to the wholesale-only NBN¹.

Telstra will be powerfully motivated to exploit all of the weaknesses in the regulatory arrangements to put itself in the strongest possible position to continue to exercise horizontal and retail market power through this period and into the future.

Again, the transitional regulatory arrangements must be framed to anticipate these risks.

¹ "As Minister Conroy has stated, the NBN operator will be structurally separated, will provide wholesale services only and will offer them on an open access basis. He has also confirmed that no retail company will be able to control the network in its own interests." Graeme Samuel, May 21, ATUG regional Conference.

INDUSTRY STRUCTURE AND TELSTRA SEPARATION ARRANGEMENTS

Vertical Integration and Reasoning for Separation

The Appropriate Aims for Separation Remedies in the Australian Context

The discussion paper gives succinct and damning summary of the negative competitive consequences of the vertical and horizontal integration of Telstra, and the damage this has done to the interests of end users.

The NBN industry structure implied in the Government's proposal represents its competitive ideal – a fully structurally separated network owner and wholesaler with no retail interests.

The transitional regulatory arrangements must reform Telstra's structure to create competition-enhancing incentives, rather than competition destructive incentives. This is needed both to create industry growth in the near term ahead of the NBN and to promote industry wide conduct that is compatible with the way in which companies will do business with the structurally separated NBN in the longer term. This holds for all industry participants, including Telstra.

Any structural remedy imposed on Telstra will cause disruption and take some time to implement. However, the primary considerations in making a choice between various separation options described on page 20 must be:

- their efficacy in maximizing consumer benefit on the legacy network for the next eight years,
- the degree to which they will create new competitive dynamics before the NBN is operational, and
- their consistency with the regulatory model that will accompany the NBN.

The various forms of separation short of full structural separation are regulatory devices that attempt to achieve two things – firstly, attempts to replicate to some degree the intended the incentives present in a structurally separated industry and, secondly, requirements for incumbents to put in place internal arrangements to give the regulatory greater transparency into their conduct.

Some forms of separation, such as accounting separation and operational separation previously tried in Australia, are designed to act as enhancements to a regulatory regime based primarily on managing behaviour. They make little or no attempt at changing the incentives that drive behaviour.

The Government intends strict separation arrangements for the NBN that preclude it completely from retail markets. This proposed structural separation makes it apparent that the Government intends to set up incentives for the NBN such that there is no driver for it to discriminate against particular retailers.

The CCC submits that the model of separation implemented in relation to Telstra should similarly be weighted toward changing incentives, rather than simply another attempt at providing new transparency tools to enhance the ability of the regulator to identify and manage anti-competitive conduct.

The separation arrangements should, in fact, encourage Telstra itself to consider divesting itself of its network activities, consistent with the Government's ideal model of the industry structure.

That is, the separation model should aim to cause Telstra's retail businesses to be indifferent to their source of access services, and its wholesale business to have no incentive to treat one retailer more favorably than another.

The only way that this can be achieved completely is through complete structural separation, and this remains the preferred option for the CCC for this reason. Structural remedies short of structural separation must be designed with resolving the incentives problem as the priority.

Regulatory Intervention Trade-offs – One-Off Structural Intervention versus On Going Intervention

As discussed above, lower level structural remedies are designed as enhancements to other remedies, and therefore must sit within a permanent regime of more intrusive industry-specific regulatory tools.

ACCC Commissioner Ed Willett recently described the forms of separation in these terms:

(F)ull structural separation is at one end of the spectrum that is designed to achieve something that cannot be achieved by any other mechanism. There is then a continuum of different structural reforms from the sort of accounting separation we have at the moment at this end to the sort of separate company structure we have in the gas access rules in Australia, whereby you have separate accounts and a separate company structure. You do just about everything you can except separate ownership. The purpose of that is to make those dealings between the affiliates, the bottleneck and the downstream component, more transparent to get good access terms in place for third parties. (see appendix)

The corollary of this is that the further away from full structural separation the remedy moves, the greater the degree of attendant regulatory intervention required to ensure compliance with the requirements for transparency and equivalence of treatment that are needed to support sustainable competition.

ACCC chairman Graeme Samuel pointed to this need for a higher degree of other regulation to be appended to non-structural separation options in a recent speech to ATUG. Mr Samuel referred to the wide range of interpretations of the term functional separation and the need to understand how that differed from structural separation.

The options include proposals to alter Telstra's structure by requiring functional separation to improve its incentive to treat access seekers and its own downstream business units on equivalent terms.

Functional separation is a broad term used to define various models which segregate particular assets and other inputs into a separate division but without requiring separate legal ownership of that division.

The key feature of functional separation models is that the network provider operates at arms length from the downstream service providers. This usually requires operations and management separation and carries the potential for decisions to be made independently by the separated division and the rest of the company.

When successfully implemented, functional separation may go some way to addressing concerns regarding the promotion of equivalence in the treatment of access seekers. However, vertical integration of any form into downstream markets, even when subject to functional separation, will not necessarily ensure equivalence.

Mr Samuel indicated that the Government's decision to insist on complete structural separation of the NBN corrected the mistakes of past Governments in allowing the integration of Telstra to continue.

Structural separation will mean the NBN operator has a clear incentive to treat access seekers on an equivalent basis. Therefore, the government's announcement provides an opportunity to deal head-on with the difficulties arising from the vertical integration of the current incumbent

The cost of trying to manage behaviour while making inadequate efforts to change incentives has been demonstrated by the continual gaming of the regulatory requirements in Australia in the past 12 years and by the abject failure of the operational separation and, before them, the accounting separation arrangements.

This gaming has no place in an NBN world, so it is important that the Government act to encourage the entire industry to move away from its habitually legalistic and antagonistic behaviour as soon as possible. This will make the transition to NBN smoother and encourage greater industry development in the meantime.

Further, there are network assets that various participants in the industry today own that will eventually be made redundant by the NBN. It would be problematic for the transition if, for example, Telstra continued to own particular network assets only because it was able to leverage downstream market power from such ownership, if only for an interim period.

To this point, the regulatory arrangements should give clear signals to remind Telstra, by its own account, that the future value to its business of copper-based access services is limited.

Telstra told the Parliament in November 2003 that it was “five minutes to midnight” for the copper network, and that ADSL was the “last sweating” of the asset. It indicated that the expected useful life of the copper access network was 10 to 15 years.²

On that timetable, Telstra’s estimate of the end date for the copper network is between 2013 and 2018. It is possible that this is a pessimistic assessment, but in the absence of other data, Telstra’s own assessments must be regarded as the most informed about the true state of repair of this asset.

Taking into account the Government’s expected time to completion of the NBN build of eight years, the alignment of the timing of the full deployment of the NBN and Telstra’s estimate of the end of the useful life of the copper are conveniently closely aligned.

It is important, however, that Telstra’s assessments about the value of retaining the copper in service is based only on rational economic analysis and not on the potential for it to leverage advantage through discrimination against competitors that is available to it only because of vertical integration.

Over time, absent this discrimination opportunity, the increasing cost to Telstra of maintaining the copper network is likely to be seen as becoming prohibitive in an environment where the superior alternative of fibre to the premises becomes available.

²Tony Warren, Telstra, group manager, regulatory strategy, told the committee: "I think it is right to suggest that ADSL is an interim technology. It is probably the last sweating, if you like, of the old copper network assets. In copper years, if you like, we are at a sort of transition - we are at five minutes to midnight."

Bill Scales, Group Managing Director of Regulatory, Corporate and Human Relations at Telstra: "The only point of clarification, just so that there is no misunderstanding, is that when we think about the copper network, we are still thinking about 10 years out. So five minutes to midnight in this context . . . could be 10 or even 15 years, just to get some context into that." Senate Hearing, Nov 2003

Maintaining the copper beyond what Telstra has identified as its useful life would be wasteful of resources at a time when the industry should be devoting all its energies to driving compelling new retail services. Importantly, it would also mean that the commercial returns on the fibre network would be retarded as traffic would be transferred to the fibre network more slowly.

It is in the interests of consumers, competitors and Telstra itself that services are transitioned off the copper network smoothly and with open and transparent industry-wide planning.

The incentives will be strong for the NBN network to offer access prices that are attractive enough convince retailers to shift their services to the new platform.

If these offers were sufficiently attractive to all retailers except Telstra, this would suggest that the functional separation regime had failed to replicate the effects of structural separation. That is, that if Telstra should regard the last mile access options as inputs to its retail service, and be indifferent to whether its last mile access came from an independent supplier or from its separated legacy network for any reason other than value for money.

If it was indifferent as to its source of access inputs, this should encourage Telstra to consider divesting itself of its basic network infrastructure to realize a capital return. It, along with the rest of the industry, could benefit from the creation of an alternative, independent network access provider with an incentive to maintain the copper as a direct competitor to the NBN until these assets had reach the end of their useful life.

Under separate ownership, the copper assets and other basic access services, such as ducts, pipes ad poles, could develop into an on going utility business, even as the copper itself becomes redundant, freed from the mixed incentives caused by its present integration of these assets with downstream retail businesses.

Preferred Non-Structural Separation Option: Legal Separation

In light of the above, the CCC strongly believes that the Government should opt for the strongest form of vertical separation of Telstra. If it is considered that requiring full structural separation would be too time consuming and complicated, legal separation is the appropriate measure.

The CCC points to Mr Willett's description of the "separate company structure we have in the gas access rules in Australia, whereby you have separate accounts and a separate company structure" as providing the model for this approach.

A form of separation of this type would give the industry the best chance at developing a new, sustainably competitive model in the up to eight years during which the legacy copper network is the primary access technology.

Such a separation model would, further, position Telstra to divest itself of activities that were not necessary or appropriate to its retail interests in the future, and stimulate the necessary rapid growth in the whole industry to support the viability of the NBN. Telstra could realize the capital value of these assets that it will no longer have any incentive to continue owning and allow those assets to realize their full independent value.

To achieve the necessary changed incentives, the conditions of any separation of Telstra should include at a minimum:

- Separate management
- Independent boards
- Remuneration arrangements for all management and staff that were based solely on the performance of the separate divisions
- Independently branded entities
- Separate information systems such that all retailers used the same systems to acquire wholesale services (including Telstra retail businesses)
- Arm's length contracting for all services from the network/wholesale business

The network/wholesale business must include all access assets – including those based on copper, FTTN and FTTH where those have been built –all regulated access services, and all wholesale services. The CCC proposes that a significant market power test be introduced to determine the level of regulation of various wholesale services within the portfolio of services provided by the network/retail business.

It is necessary to ensure that all wholesale services are separated from the retail activities to remove the incentive for anti-competitive cross-subsidisation or price discrimination.

The CCC does not outright reject the three part separation approach used in the UK and since copied in New Zealand but submits that it is important that it is not slavishly emulated in Australia without thorough examination of the implications. The model proposed for the NBN of a simple two part wholesale/retail division of industry activities suggests that the Government does not believe that future access technology is conducive to models of separation based on the legacy copper bottleneck.

The CCC agrees with this approach.

However, the three part approach appears to be designed to ensure that there is maximum transparency of the costs associated with the most basic copper access services, especially the unconditioned local loop. It is crucial that there is no opportunity for the price of this service to be discriminatory. Separately, while the prices for these services should be regulated to cost, this does not necessarily bear on the competitiveness of the retail industry as long as there is consistent pricing of the service to all retailers.

The CCC believes that the ACCC should be asked to confirm that it will be able to achieve the maximum insight into costs and potential anti-competitive practices before a final decision is made as to the separation model.

Horizontal separation

The competitive consequences of the horizontal integration of Telstra, especially through its ownership of the HFC cable network and 50 percent of the Foxtel business, were documented by the ACCC in the Emerging Market reports in 2003.

The discussion paper refers at some length to the problems associated with its ownership of the HFC cable and the problem of access to content. It proposes options of

- Restrictions on future Telstra investment in media and communications businesses, and
- Requiring it to divest the HFC network.

The Emerging Markets report proposed requiring Telstra to divest itself of both the HFC cable and the Foxtel shareholding.

More recently, the Graeme Samuel has discussed the provisions of the TPA that could be relevant to the issue of content control and competition.

The ACCC monitors the content sector closely to identify emerging competition concerns. There are a number of provisions in the Trade Practices Act that would prohibit attempts to use the control of content and the communications pipes to substantially lessen competition in downstream markets.

For example, section 45 of the TPA prohibits companies from entering any arrangements that result in a substantial lessening of competition. Section 47 is even more explicit: exclusive dealing that causes a substantial lessening of competition is illegal. The ACCC could also consider the use of section 46 which relates to the misuse of market power.

Given the increasing synergies between the telecommunications and media sectors, it is also possible that companies within the sector will look to merge to gain a strategic advantage over their competitors. Section 50 of the TPA prohibits any such deals that would have the effect of substantially lessening competition in a market.

However, the CCC submits that these provisions have been discussed by the ACCC publicly in the context of concerns about the anti-competitive implications of Telstra's horizontal integration for several years.

It has not, however, acted to bring any of these issues before the courts to be tested.

The CCC submits that the experience in relation to attempts to regulate the consequences of horizontal integration have mirrored those related to vertical integration. That is, the remedies available have been designed to manage anticompetitive behaviour, not to eliminate the incentive to behave anti-competitively.

Like the regulatory tools to manage behaviour leverage vertical market power, these have proved inadequate. The incentive to exploit market power is simply too strong. This incentive could increase as a result of other changes to the regulatory arrangements.

If the regulatory arrangements introduced to deal with vertical integration are sufficiently strong to replicate the changed incentives that would result from structural separation of the legacy copper network, Telstra will be forced to accept that its ability to leverage upstream market power from the ownership of this network into retail markets will be curtailed.

However, Telstra would retain tremendous horizontal market power through its dominant retail market share position in fixed and mobile, and its ownership of content through Foxtel. This horizontal market power could persist even if the delivery of all of these services were to shift to the new NBN platform off the copper completely.

The concerns associated with exclusive content arrangements would be mitigated, if not removed, by the divestiture of Foxtel and the HFC cable. Other horizontal integration issues, however, – such as the lack of transparency of call interconnect arrangements between fixed and mobile networks – are not address by proposed action on the HFC and Foxtel.

The bundling of fixed and mobile voice services is of concern because of Telstra's domination of fixed to mobile calls. This reflects its dominant market

share of fixed line services (about 85% of the retail market and about 94% of the wholesale market) and its dominant position in mobile (about 42%)³

The CCC submits that there is a need for regulatory tools to aid transparency in relation to areas of possible price discrimination and anti-competitive cross subsidy. This is especially pertinent in relation to the internal call interconnect arrangements between Telstra's mobile and fixed businesses to identify anti-competitive pricing of voice bundles.

To this end, the CCC recommends that Telstra be required to implement operational separation arrangements between its fixed and mobile divisions. The CCC proposes the Government consider the separation requirements on RBOCs that were employed in the US in the 1990s when mobile communications was nascent to encourage the development of a competitive mobile industry.⁴

Horizontal Separation Recommendation

The CCC submits Telstra should be required to divest itself of its interests in the HFC cable and Foxtel, in line with recommendations from the ACCC Report on Emerging Market Structures in 2003.

Telstra, it should be noted, campaigned strongly to require Optus to invest in its HFC cable as an alternative to the use of Telstra copper, culminating in an Australian Competition Tribunal proceeding that would have exempted Telstra from providing access to the copper network to Optus.

Although this action was unsuccessful, it was based on Telstra's contention that the HFC network was capable of providing competition to the copper network. This must be equally true of the Telstra HFC network, yet Telstra was silent on the issue of its own joint ownership of HFC and copper networks.

The CCC submits that Telstra's own arguments in relation to Optus vindicate the ACCC's proposal from 2003 that Telstra should divest the HFC cable ownership in order to create more effective competition.

³ <http://www.accc.gov.au/content/item.phtml?itemId=861198&nodeId=c861c148488616ea3b1f85f4713b837d&fn=Hutchison%20public%20submissions.pdf>

⁴ Separation of Telstra: Economic Considerations, International Experience. WIK-Consult, June 2009 (report for CCC)

THE NEGOTIATE/ARBITRATE PRINCIPLE, XIC AND XIB

Price Determination Powers

The discussion paper recognizes that the Part XIC arrangements have profoundly failed to deliver the intended outcome of commercially negotiated, timely and reasonable access prices, terms and condition to declared services.

The arrangements have instead proved to be fertile ground for gaming and delay, causing uncertainty and retarding industry investment, to the absolute detriment of the long term interests of end users.

At the core of this has been the negotiate/arbitrate principle. This principle has failed to accommodate the reality that the access provider (Telstra) was an unwilling seller because it regards access by competitors as detrimental to its own retail interests.

In this situation, the incentive on Telstra has always been to resist providing access to competitors. There has been no incentive to drive it toward genuine negotiation. Further, there has been no effective disincentive this conduct in the form of than regulatory sanctions.

The CCC has often described the model that has evolved in practice as being arbitrate/litigate, or, more recent, litigate/appeal.

The CCC submits that a move away from negotiate/arbitrate to a model similar to that described in option two on page 15 of the discussion paper would be the only truly effective means to resolve these problems. Further, a price determination approach would be a more suitable arrangement for the future regulation of pricing by the NBNco.

Option one amounts to tinkering with the regulatory arrangements that would simply result in a shift of gaming tactics. The CCC rejects this as a viable option.

For example, placing time limits on regulatory processes has been tried before. Telstra's response was to delay lodging material with the ACCC until near the end of the deadline, then appealing on administrative grounds any unfavorable decision on the grounds that insufficient weight was given to this material. Allowing parties to vary undertakings would not stop the party from lodging serial undertakings, but would likely result as well in undertakings also being varied continually within one proceeding.

Only a move completely away from negotiate/arbitrate to price determinations represents a possible break from the failed past.

In the transitional period, the CCC submits that the most recent prices determined by the ACCC in indicative price, and prices from arbitration, and all present declarations processes (as at a starting date of December 31 2009) be deemed to be the determined prices for a period ending July 2012.

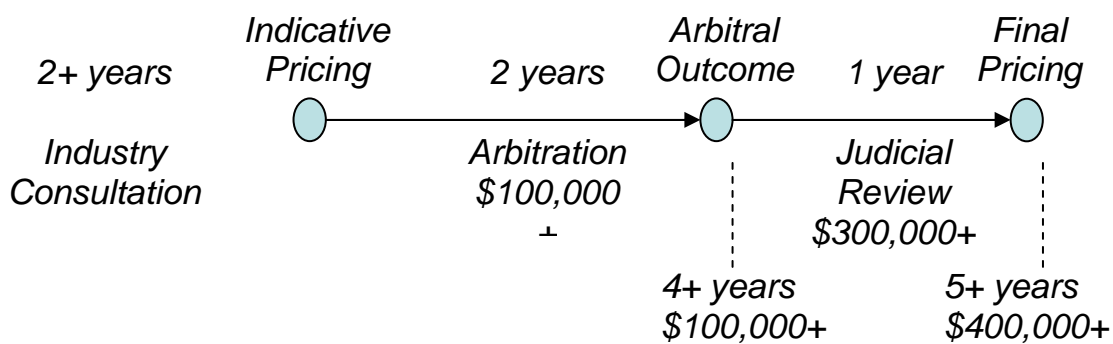
Redeclaration processes would commence December 2011, consistent with the proposal below about the timing and scope of regulatory reviews. This would be determine the next round of pricing for declared services.

Price Determination: Recognising Reality

The CCC submits that empowering the ACCC to determine prices would not, in fact, be a great departure from the situation prevailing in practice today.

The present arrangements result in the ACCC inevitably being required to set prices through arbitration. However, this is achieved only on a bilateral basis, through disputes, and is slow, expensive and uncertain. Further, the process takes so long that the period during which they apply is usually far shorter than the period spent reaching a resolution of the pricing dispute. Once a service is redeclared, the price dispute/setting process begins again.

Typical Pathway to Price Determination Under Present Arrangements



One result of the failures of the present arrangements is that the Commission has been forced to develop the skills and resources necessary to determine prices for

almost all presently declared services, and is therefore equipped to perform this function under a price determination regime.

Departure from Determined Prices

The CCC submits that it is reasonable that there should in principle be scope for parties to depart from these regulated prices by agreement and under the strict supervision of the ACCC.

However, there is risk that this could be used to manipulate competitive outcomes if it is not closely regulated.

The CCC submits that, firstly, regulated prices must be the upper bound of prices in the market, and, secondly, the conditions under which lower prices can be offered must be clearly defined.

Parties should be able to enjoy lower access prices only in circumstances where it can be demonstrated that these reflect identifiable and quantifiable economies. That is, if, for example, an access seeker can show that an investment it has made has resulted in a saving that is passed on to the access provider when an upstream service is acquired, the access seeker should be able to enjoy a benefit in the form of lower access prices commensurate with the saving passed through.

This would encourage efficient investment and product differentiation.

However, there should be no scope for any subjectivity in the level of access price discounts. That is, the same level of discount should be available to all access seekers.

Further, this discounting arrangement can only be contemplated if there is complete business and systems separation between Telstra's wholesale and retail businesses. All transactions between the two entities must be completely at arm's length and entirely on the same basis as transactions between Telstra Wholesale and any other access seeker.

It would be completely inappropriate for Telstra to be able to maintain a shared provisioning system, for example, and to then claim that this represented an efficiency that entitled it to a discounted access price.

One of the problems that access have faced in recent years is that the basis upon which Telstra offers differentiated prices is unregulated and opaque. There is reason to believe that Telstra has at times engaged in strategic discounting in

order to disadvantage certain competitors as against others, to Telstra ultimate advantage.

This problem, too, is a consequence of Telstra's vertical integration. Telstra has an incentive to use its upstream control over bottleneck wholesale services to manipulate downstream competition in favor of its own retail activities. Defining strictly the basis upon which discounts can be offer should ameliorate this problem.

If prices are offered to particular access seekers on a price that departs from the ACCC's determined price level, a copy of the commercial agreement should be filed with the ACCC. The ACCC would be able to examine these agreements to determine if there was evidence of anti-competitive conduct.

These arrangements should be reviewed in 2011 to determine if they are functioning as intended.

Price determinations and consistency with the NBN

In a future NBN world, a structurally separated network would not have an incentive to discriminate between retailers in the way Telstra has today. However, it would have an incentive to maximize the prices that it received for access, and would have monopoly market power against access seekers.

Therefore, it is important that the regulator has strong and unequivocal powers to regulate prices that the NBNco can charge for these crucial access services.

It has seen that the negotiate/arbitrate model allows Telstra to persuade some access seekers (particular smaller service providers) to accept higher prices or less favorable terms simply in order to avoid drawn out regulatory processes, even though these prices may be inconsistent with the guidance given to the market by the Commission through indicative prices.

This opportunity to leverage market power would also be available to the owner of an NBN if it operated within a negotiate/arbitrate regulatory model.

Further, the regulation of prices for NBNco services should not be bedeviled by the same pricing methodology problems that have been a source of conflict in telecommunications over the past 12 years. The cost of building the NBN should be able to be clearly identified, which means cost-based pricing reflecting the actual cost of the build should be readily possible. The CCC understands this would also be consistent with practices in other utilities. (See Appendix 3)

The CCC therefore submits that an immediate move to a regime in which the ACCC determines access prices, and where undertakings provision were

removed, would be consistent with the most appropriate arrangements for the future regulation of the NBNco.

Merits Review

The CCC notes the argument for a merits review to be introduced as a safeguard to regulatory error under a move away from negotiate-arbitrate toward price determinations by the ACCC.

However, this argument for procedural fairness must be seen in the context of the unremitting and ruthless regulatory gaming that has blighted telecommunications for a decade (see above).

Safeguards against the risk of regulatory error need to be balanced against the certainty that any appeal opportunity will be used to disrupt, delay and load cost onto regulatory processes. These costs disproportionately disadvantage market entrants and advantage incumbents in protecting their existing revenues.

Merits reviews of arbitrations were removed by the Parliament in 2001 because it concluded that Telstra was abusing the provisions. However, the merits review option was retained for undertakings and Telstra immediately transferred its gaming energies into that realm.

The decision by Telstra to take to appeal the ACCC's April 2009 rejection of its undertaking for a \$30 ULLS access price underlines the fact that there is every reason to believe that Telstra will continue to display this attitude.

It is difficult to imagine a matter on which the position of the regulator has been made clearer than the price proposed by Telstra in this undertaking. The \$30 price has been proposed by Telstra and rejected by both the ACCC and the Australian Competition Tribunal repeatedly since 2005 when Telstra first sought to force access seekers to pay it. Yet Telstra has again and again employed the regulatory decision making and review processes through every stage available, rather than accept the umpire's decision.

The pernicious aspect of this conduct is that other stakeholders have no discretion about whether or not to participate in these processes. The regulator must begin a process as soon as Telstra initiate a request. The risks to competitors' interests of an unfavorable decision are too great for them not to make representations on their own behalf.

The latest Telstra ULLS appeal must be seen in the context of the history of constant regulatory gaming and legal disputation that make the communications

industry stand apart from other regulated industries.⁵ It provide persuasive and compelling evidence that establishing a workable regulatory regime must, on balance, take precedence when the Government weighs the various options for appeal processes.

Telstra's conduct means that it must be assumed that any opportunity for appeal will be used, no matter how weak merits of its case.

This militates against the introduction of a merits review right accompanying a move to price setting powers.

The risk of regulatory error, on the other hand, is mitigated by the continued availability of judicial review, both under the ADJR Act and under the common law.

However, it is important to note that the balance in favor of limiting the scope for pricing decisions to be reviewed is heavily influenced by the impact that Telstra's integrated structures has on its behaviour.

This balance might shift if there was in place a form of separation of Telstra that removed the incentive for Telstra to seek to discriminate against access seekers to its network, such as by delaying their entry into markets or to increase their costs relative to Telstra's retail activities.

The CCC notes in this regard that the discussion paper proposes to consider whether the Government should review of the overall approach to regulation in 2011.

The CCC believes that such a review, coming so soon after the processes leading up to and including this process, should be limited to specific matters.

One such matter should be to review the issue of merits reviews on price setting by the ACCC.

If it was clear that;

- the separation arrangements pertaining to Telstra had been bedded in and;
- there was evidence that they were adequately strong to have removed the incentive for Telstra to game any available process,

the balance between protecting against regulatory error and protecting the workability of the regime might have shifted.

⁵ "Since 1997, the ACCC has been notified of a total of 157 telecommunications access disputes. This is in stark contrast to the three access disputes that have been notified to the ACCC across all other sectors of the economy." Graeme Samuel, Address to ATUG Regional Conference May 21, 2009.

At that time the CCC would be open to the reconsideration of the introduction of a merits review on price determinations.

The regulatory error risk raised in the meantime would be limited if the Government accepts the CCC's recommendation that prices initially are determined by reference to previous decisions in arbitrations and indicative prices processes.

Undertakings

The CCC does not believe that voluntary undertakings should be retained, either alongside or as an alternative to price determinations by the ACCC.

Undertakings were intended to provide a vehicle for industry-wide price, terms and conditions for declared services to be set, allowing the industry to avoid the expense of multiple bilateral disputes. That is, they were perceived to have a utility within the negotiate/arbitrate framework because access providers could be spared the unnecessary expense of bilateral negotiations and arbitrations with all access seekers for the same service.

But the underlying negotiate/arbitrate principle has been shown to be ill-conceived. If negotiate/arbitrate principle is replaced with a price determination power to the ACCC, it is difficult to see any logic or utility to retaining undertakings.

Against this, the CCC submits that the history of the abuse of undertakings demonstrates that there are likely to be negative consequences in retaining undertakings. Undertaking, perhaps more than any single element of the regulatory regime in the past six years, have been used to force millions of dollars in resources to be wasted in regulatory gaming that literally has no end.

The example of the repeated attempts by Telstra to force access seekers to pay \$30 for access to the ULLS in band 2 (discussed above) is the clearest example of how the undertakings processes under Part XIC have been gamed to the point where they are unworkable. The CCC (and the Commission itself) has argued for years that the undertaking process is being used only for the purpose of creating expense, disruption and uncertainty and not to streamline the process of resolving the prices, terms and conditions for services, as intended.

Telstra has repeatedly presented undertakings that are counter to what the Commission has said are the minimum acceptable standards. They are inevitably rejected, and just as routinely re-presented so that the whole process begins again.

Separately, the ex ante undertakings provision were designed to facilitate investment certainty.

However, these provisions, brought into effect at Telstra's behest because it said it was necessary in order for Telstra to contemplate investment in NGAN, were then rejected outright by Telstra when it was agitating for the right to build an FTTN network under its preferred regulatory terms. The provisions were used by the FANOC consortium to present its FTTN proposal but in the face of Telstra political pressure, this process was cut short and replaced by one overseen by the Government.

The Government itself has now stepped in to build the NBN.

It is reasonable to conclude from this experience that investments of the magnitude for which the ex ante undertakings provisions were designed will be too political contentious to be managed outside of Government processes. It is unlikely that, given the NBN proposal, these provisions will be relevant in the future.

Conclusion on Undertakings and Related Provisions

It is clearly time that the undertakings regime was removed. Under a price setting regime, it is superfluous. Experience shows that it is almost only ever been used to prevent certainty for access seekers, the opposite of what was intended.

Similarly, the CCC submits that there should be no facility for applications to have geographic locations exempted from declaration outside of the normal processes for the reconsideration of the declaration of services.

The experience of this in the past two years has demonstrated that it is risky, inconsistent with the process of declaration itself, enormously disruptive and expensive. The fact that the decisions arising from an exemption process are subject to merits review is also an anomaly, given this is not available within the declaration processes proper.

The CCC therefore submits that s152AT and associated sections also be repealed.

Part XIB Reforms

The Part XIB competition notice regime has been a great disappointment for the competitive industry and has reportedly fallen out of favor with some in the ACCC also.

It is the understanding of the CCC that Part XIB was intended to provide a tool that the ACCC could use to intervene quickly where it had reason to believe that anti-competitive conduct was occurring. It was intended to be a device that could be used to correct that conduct quickly, limiting the damage caused to the affected market.

The lower threshold test for the Commission to initiate action under Part XIB should provide a strong indication to the regulator that this was the intention of the Parliament.

They have been numerous instances where the industry has complained of what appear to be clear instances of anti-competitive conduct by Telstra. However, since 1999, the effectiveness of the competition notice regime has been diluted to the point where the industry has now received the clear message from the ACCC that it does not intend to use this regulatory tool.

Each time a competition notice was issued, Telstra took longer to change the offending conduct to the point where it satisfied the Commission that the notice could be removed. The Commission has also increased the evidentiary burden on access seekers each time it was to take action under Part XIB.

In effect, the CCC submits that Telstra engaged in a game of chicken with the Commission. This culminated, on the last occasion on which a Notice was issued, in a successful legal challenge against the notice on technical administrative grounds. The Commission responded by walking away from the dispute.

Legislative changes, such as the introduction of the consultation notice, further reduced the usefulness of the Part, and gave mixed signals about the Parliament's intentions.

The CCC submits that the existence of a strong tool such as Part XIB remains essential given the history of constant belligerence toward competition that Telstra has demonstrated.

Unlike the experience in almost every other country in the past 20 years where competition has been introduced to incumbent providers, the instances of disputes initiated by Telstra in Australia has continued to spiral upward, with Telstra able to ensure that even the most basic access conditions are never finally "settled".

Coupled with the campaign of sabotage tactics – such as the efforts to resist allowing competitors into exchange buildings – this demonstrates that there continues to be a need for a regulatory tool such as that the Parliament intended to provide the regulator when it framed Part XIB.

The CCC believes that there are specific reforms necessary to Part XIB, however.

The consultation notice requirement should be revoked, as per option one on page 17 of the discussion paper.

This regulatory element was introduced because Telstra complained that it could be taken by surprise by the issuing of a competition notice and that this was unfair. The CCC submits that in a practical sense this is simply not the case. Telstra knows when its actions give rise to competitive concerns because it is to Telstra that wholesale customers first complain, even before Telstra is contacted by the ACCC.

The consultation notice has also created the unforeseen problem that arose when the last competition notice was issued. That is, that Telstra successfully exploited a gaming opportunity by making an administrative challenge to the issuing of the notice. The Parliament introduced the consultation notice because it was concerned about fairness. Instead, it was used to cripple the provisions entirely through a cynically opportunistic and litigious legal side door.

In the past, the CCC has not thought it appropriate that the Commission indicate what Telstra should do specifically to remedy anti-competitive conduct. It was not clear that the Commission had the wherewithal to make appropriately commercially informed directions.

However, the CCC believes that the balance has now been shifted by Telstra's tactic of delaying and avoiding responding to competition notices for as long as possible. The provisions were intended to result in quick outcomes. Telstra has shown that it can enjoy long periods of advantage while engaging in "negotiation" with the Commission about how to resolve a dispute.

A requirement for the ACCC to provide "guidance" to Telstra in these circumstances, as per option two on page 17, would only exacerbate this problem. Telstra would then use this obligation on the Commission to spend months in negotiation with the Commission about the appropriate way for it to respond to the Commission's "guidance".

The CCC would therefore oppose this option.

The CCC submits that option three, providing the Commission with the ability to impose binding rules of conduct when issuing a competition notice, is the most effective option for bringing Part XIB back to its original intention. That is, providing a regulatory tool that can be used quickly and effectively in the face of serious anti-competitive conduct.

The CCC submits that it is preferable to retain Part XIB with the addition of the binding rules of conduct remedy than to introduce binding rules of conduct and repeal Part XIB.

The CCC believes that there is value in maintaining continuity in the parts of the Act designed to deal with anti-competitive conduct. There are circumstances in which Part XIB has been employed in the past that gives some guidance to the industry as to what is inappropriate conduct.

Further, the CCC notes that the Government proposes to introduce the “effects” test in Part 4 of the TPA as a threshold test for general anti-competitive conduct provisions. It would seem consistent with this that the test be retained in Part XIB. The CCC therefore prefers option three to option four.

It is important, too, that the ACCC is reminded that the Parliament enacted these provisions because it expects them to be used, and not left on the shelf because of a perceived legal risk that they will be successfully challenged.

The CCC does not believe it is the role of the Commission to decide that parts of the Act can be ignored because it does not believe that they are drafted to give the Commission sufficient comfort about how they will be interpreted by the courts.

Strengthening the provisions with the changes described above will give an indication to the industry and the Commission that the Parliament remains concerned to ensure that an effective, quick response remedy is available and used in instances of anti-competitive conduct.

The CCC submits that this should also be outlined in the explanatory memorandum to the Bill to emphasise this message.

However, no amendments to Part XIB will be effective if the regulator refuse to employ the remedy where there is a situation that satisfies the criteria for it to be used.

The CCC therefore recommends that the Government further amend Part XIB to make it clear that there is a positive obligation on the ACCC to use the remedy where it has reason to believe that there is conduct occurring that could have the effect of significantly lessen competition.

The CCC further submits that the Government should provide for specific funding to be made to the Commission with the express purpose of resourcing it to run test cases where it believes there has been a breach of Part XIB.

These actions combined should be sufficient to make Part XIB perform the functions for which it was originally intended.

OTHER ISSUES

Wholesale Bitstream and Regional Services

The deployment of the NBN will mean that access seeker will be reliant on what are in effect wholesale services. Clearly, it is the intention of the Government that the suites of services includes some type of a bitstream service that allows access seekers the highest level of control possible over the end user experience that they can offer. This is the basis on which service and price differentiation, and therefore competition, will be built.

At present, there is no equivalent to a declared bitstream service. Indeed, the ACCC has refused to declare even a wholesale xDSL service, relying instead on Part XIB actions in the past to make access to such a service available.

Yet there are significant parts of the country where competitors have not found it viable or possible to invest in making available ULLS-based broadband services and where Telstra has resisted strongly offering a competitive wholesale alternative. In some of these locations, the network architecture precludes the use of the ULLS (such as where a RIM is installed). In others, such as regional areas, population density and high Telstra access costs conspire to keep out investment by competitors.

The Government's backhaul blackspots funding program must be designed with a view to consistency with the approach that the Government has signaled it wishes to take with the NBN; that is, designed for seamless transition and complete wholesale/retail separation. The CCC has commented on this issue in a separate submission to the Department.

This submission also discusses the importance of declaring bitstream to open business case for entry of retailers into regional markets.

It can also be expected that competitors will over time begin to wind down invest in ULLS as the deployment of the NBN proceeds.

The CCC is of the view that it would be appropriate and valuable for the equivalent of a bitstream service to be declared immediately to smooth the transition to the NBN, initially in regional areas.

2011 review of regulatory arrangements

The discussion paper indicates an intention to consider a review of regulatory arrangements in 2011. As discussed above, the CCC believes it is premature to conduct a full review of regulatory arrangements at that time, notwithstanding the concerns raised about ensuring that the arrangements are consistent with convergence between communications and media industries.

However, the CCC does believe that there will be a need to examine how the regulatory arrangements relating to separation arrangements are proceeding and whether further action is needed, particularly in relation to horizontal integration issues, or whether some arrangements can be relaxed or changed, as per the discussion about merits reviews of pricing determinations above.

It may be appropriate for the Government to proceed with a limited review of specific aspects of the arrangements only in 2011, with a broader scope review to commence once the NBN is reaching scale. That is likely to be closer to 2013, based on the Government's indicative timetable for its rollout.

USO

The CCC has reproduced below its 2007 submission on the USO. The nature of the USO must clearly be reconsidered, and is most likely to be most appropriately defined as a right to an access service, provided by a separate wholesale/network company, with a retail service provider of last resort guarantee from the Government attached.

The CCC submits that the future of the USO beyond the NBN rollout is best determined after the NBN implementation program is completed. The CCC submits that the NBN, once fully operational, is the natural provider of the USO.

In the meantime, the network/wholesale operator in an effectively separated Telstra would similarly be the natural home of a USO access guarantee. The CCC does not believe it is necessary or desirable for this to continue to be funded through a levy on retailers, as discussed in the below submission.

Further Information

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March 3 2009 NBN Senate Select Committee Evidence from Commissioner Ed Willett

Mr Willett—I am constrained to some extent, but let me say this. Certainly in my time with the commission, and I am in my sixth year now, and I think before that, the question of the structure of Telstra, its size, its ubiquity across all services, has been a prominent issue in the facilitation of competition. The early work I can remember was in 2004 when we did some work on emerging market structures, where we advocated that some horizontal separation arrangements should be considered, and they were designed to try and invigorate the sort of cable versus copper competition we have seen overseas, particularly in the US and some European countries. That was really staved off in Australia because of Telstra's involvement in pay TV. More recently, we have said some things about functional and operational separation of course involved in the development of some enhanced accounting separation rules. You would have seen comments by the commission chairman particularly that we are not terribly enamoured of those current rules. So, yes, it is an issue.

I would like to say this about the difference between structural separation and some lesser form of structural reform, because I know that has been an issue for you. The important point that is sometimes lost is that full structural separation which involves the bottleneck being owned by someone different from downstream providers is designed to remove all incentives on behalf of the bottleneck owner to favour a particular downstream competitor. It is the only way to do that. That is not to say that functional separation, some lesser form of structural reform, does not serve some purpose, but it never deals with that basic incentive for the bottleneck to deal with its affiliate downstream on more favourable terms than the competitors of that downstream firm. The only way to deal with that affiliate problem is to get rid of the affiliation.

Senator NASH—Yes.

Mr Willett—Lesser forms of structural reform are designed to make more transparent the provision of bottleneck services and dealings with the downstream affiliate. The purpose of that is to make it possible, easier perhaps, to make judgements about whether access terms and conditions to third parties reflect the sort of terms and conditions that are implicit between the bottleneck and the downstream affiliate. The reason that is important is that, if there is not equivalence between services provided internally by the affiliates and externally to third parties via access, competition downstream is distorted and you do not get effective competition downstream.

So it is important recognise a couple of things. Firstly, full structural separation is at one end of the spectrum that is designed to achieve something that cannot be achieved by any other mechanism. There is then a continuum of different structural reforms from the sort of accounting separation we have at the moment at this end to the sort of separate company structure we have in the gas access

rules in Australia, whereby you have separate accounts and a separate company structure. You do just about everything you can except separate ownership. The purpose of that is to make those dealings between the affiliates, the bottleneck and the downstream component, more transparent to get good access terms in place for third parties.

Mr Willett—The common example is of course the UK and their functional separation approach. I certainly see some advantages and some desirable aspects to that reform process. It is perhaps early days to make definitive judgements about how successful that will be, but we certainly have our eye on that as perhaps a lesson in a form of functional separation. In terms of structural separation you can look to Singapore. They have a quite successful approach and have ended up with a fully structurally separated network and service provider who is willing to provide services at very low prices. I think the broadband access price is US\$9 a month in Singapore. Singapore is of course a different country—it is very urban—but that is an impressive result. There are other examples throughout Europe of different approaches to structural reform. I do not know that I want to single out any particular one for favoured comment. In all of this, the whole structural reform debate is still in relatively early days. There is certainly a lot of thought going into it in a lot of countries and it is certainly on the agenda of a lot of countries.

Appendix B

CCC Submission to Universal Service Obligation Review

October 2007

Introduction

The CCC welcomes the opportunity to comment on the Universal Service Obligation.

For the purpose of this submission, the CCC is considering only the STS elements of the USO. The payphone obligations can and should, the CCC submits, be considered discretely, especially given the contentious decisions in recent years to allow Telstra to increase the cost of local calls through payphones followed by the removal of many thousands of payphones by Telstra. The future of the obligations surrounding this service is properly a matter for the Government and Telstra to resolve.

Summary

The CCC submits that the conclusions and recommendations of the departmental review of the USO in 2004 demonstrated two points very clearly: Firstly, Telstra carries far less burden than it claims to bear as a result of the USO when all relevant factors are taken into account. Secondly, the negative impact that the USO levy places on the competitive industry is disproportionately large compared to whatever burden Telstra might bear.

Developments since 2004 have not made these conclusions any less valid. Indeed, if anything, it is likely that they have made them more so.

The Department has advised the CCC that it believes it is beyond the scope of this review to take an holistic approach to examining the Government's various responses to what are seen as social and/or political obligations to extend the reach of telecommunications services further or faster than is occurring without subsidies to operators or end users. In the absence of such an holistic approach, the CCC submits that it is not possible to sensibly re-design the USO. All that can be reasonably achieved is that the harmful effects of some of the present design elements in the USO, especially the USO levy, can be removed.

It is clear that there is a great deal of overlap between Government programs and proposed Government-promoted investment. It is possible that some programs are even working at cross purposes. Further, this process of reviewing the USO arrangements is being duplicated in the Expert Taskforce process designed to assess bids for a fibre access network.

In this environment, it is not possible to make decisions about major redesigns to the USO arrangements. This process should confine itself to improving the present arrangements and proposing a further, more detailed review of all telecommunications subsidy arrangements after decisions are made in relation to the fibre access proposals. This paper suggests an approach to beginning such an inquiry at the appropriate time.

The CCC submits that the preferred option of the Department in 2004, that Telstra absorb the cost of the USO, is still the best option for this review to recommend until such an holistic inquiry is undertaken. It is clear that Telstra accrues substantial intangible benefits from being the Primary USO Provider. On the other hand, it is equally clear that the arrangement whereby the USO is levied on other carriers is harmful to competition. These conclusions were reached in 2004 report and the CCC does not believe there is any evidence to suggest that there have been changes in the market that invalidate them.

Why Telstra Burden Claims are Not Credible

As the 2004 review concluded, debates about the cost of the USO are ultimately beyond consensus resolution. Attempts to accurately model the costs of the USO will never be conclusively resolved because fundamental methodological questions will always be in dispute. To engage in that discussion will not advance the policy debate beyond the point it has reached in the past.

The 2004 report rejected the option of developing a new cost model to determine the level of the USO on compelling grounds. These included:

- The complication and cost of developing a model,
- The time it would take to develop a model, and
- The likelihood that the output would remain contentious.

The CCC submits that these concerns remain valid today. Indeed, the level of disputation and conflict in the industry has reached an all time high in the three years since the Department reached the conclusion that an agreed USO cost model would be impractical. This suggests that attempting to cost the USO through a detailed model would be untenable because the disputation that would arise as a result would likely continue for many years and could even result in court action.

However, Telstra repeated but unsubstantiated complaints of immediate financial distress, and subsequent demands for more subsidy, should be dismissed for two reasons: there is no evidence that the burden is material to Telstra or growing, and there is evidence that Telstra enjoys substantial intangible benefits from being the USO provider, which are growing.

As has been discussed in past reviews, and as noted in the present discussion paper, an analysis of Telstra's overall financial position suggests that the impact of the USO is immaterial to it.

Telstra's EBITDA margins last year of 41.4%, and its forecast that this will rise to 47-48% by 2010, suggest that there is substantial financial capacity for it to absorb the cost of cross-subsidies inherent in the present USO arrangements. Also, Telstra in 2005 announced what it called a transformation program designed to massively reduce its internal costs. It is forecasting cost savings from 2007 to 2010 of \$1billion. Telstra has not indicated publicly how this is reflected in reduced internal USO delivery costs.

Equally importantly, retail market behaviour by Telstra and other carriers shows that national average pricing (i.e cross-subsidy between customers) evolves naturally in markets, and it therefore cannot be assumed that Telstra would not cross-subsidise to retain USO customers (given the value of intangible benefits) even if it were not required to do so. This means there is a risk that Telstra is presently being subsidized to do what it would do to a large degree anyway.

Further, since 2003, Telstra has been engaged in so-called line rental rebalancing, and this has progressed to the point where the ACCC has concluded that Telstra now recovers the cost of providing a line separately to its recovery of the cost of providing calls. To the extent that there was an access deficit underlying arguments of a USO deficit, this would appear to have been ameliorated through this reallocation.

There is also the question of the intangible benefits Telstra enjoys as the PUSP, which was also considered in the 2004 review.

These benefits have never been taken into account in determining the level of the USO levy, but there is some evidence to suggest that they have increased. The CCC submits the following intangibles that the 2004 review identified as some of the benefits to Telstra have increased in value since that report was authored.

- Life cycle effects. Telstra argues that all unprofitable customers are subsidized by the USO, yet some of those customers will become profitable over time. This is true for customers in Greenfield estates, but the increased take-up of both dial up Internet and broadband since the 2004 review suggests that more customers are likely to fall into the category of pre-profitable rather than permanently loss making. Telstra, as the USO provider, is subsidised to make these users its customers for voice services, and is in the box seats to on sell data services to them. Competitors enjoy no such advantage.

- Ubiquity. Again, there is evidence that ubiquity has become more valuable to Telstra. It's decision to close its CDMA network and build the NextG network, to which it offers no wholesale or roaming access, has been accompanied by extensive advertising based on Telstra claims about better coverage than that offered by competitors. Combined with the increased use of retail bundling in telecommunications markets, this demonstrates a powerful demonstration of the increased value Telstra itself places on ubiquity. This advantage is not confined to residential markets but is especially important in the valuable corporate market.
- Brand enhancement. In addition to the above, Telstra has been very aggressive in promoting its regional and rural activities as evidence of its "patriotism" and has counter-pointed this with attacks on competitors as being "foreign".
- Network Effect. The growth in broadband, as discussed above, means that there has been a new mechanism for Telstra to benefit from the network effect that it enjoys as each new service is added to its network. This is particularly important when seen in the context of Telstra preference for exclusive content deals. Content providers are more likely than ever to defer reaching supply agreements with other network owners if they believe they will be able to reach an exclusive agreement with Telstra that incorporates multiple delivery platforms, including fixed line platforms that are subsidized through the USO.

Telstra's argument about the burden that it suffers as the principle USO provider also seems to imply that it is required to build a network to all locations in order to be in a state of "readiness". The CCC submits that there is no reason for Telstra to do any such thing. The CCC is aware of instances where other carriers, notably TransACT in Canberra, have agreed to provide the USO. If Telstra's chooses to build alongside such a network (and it has indicated it will not) that is a business decision by Telstra and should not attract additional subsidy. If Telstra does not decide to duplicate a competitive rollout, it runs counter to its argument that it needs to build network to satisfy the USO that it would otherwise not build.

The Harm to Competition From the USO Levy

The 2004 review found substantial evidence that the present USO arrangements were harming competition. Chief among these were the ways in which the USO deters market entry and revenue growth and creates distortions in other programs. The CCC submits that the USO levy's impact in distorting investment in networks might be at cross purposes to the very intention of the USO

Some of the ways in which the USO harms competition are:

It reduces Telstra's costs and increases costs of competitors seeking to invest. Taxing revenue reduces incentive for market growth, especially into lower margin markets. Also disincentive to invest early in new technology because tax applies to revenue during "pay-back" period when the revenue might increase but margins are slimmest. Double disincentive to market share, because TLS claims lost share mean it must have increased subsidy. This in turn reduces the pressure on TLS to invest. The scheme contains no incentive to invest or innovate.

It creates an advantage for Telstra when it is competing for other subsidies. TLS payment of \$98 million of the ABG total pool of \$162.5 million an example.⁶ TLS paid to turn on ADSL in exchanges where it had said it would not provide the service without competitive entry. USO subsidises its presence in those exchanges, it is now further subsidized to provide an additional service (ADSL) against competitors.

This is just the latest regional grant process where Telstra was the sole or largest beneficiary because it has the largest existing network in regional areas and can therefore offer the most competitive proposal against those who need to begin from a low or non existent investment base. This in turn further entrenches Telstra's incumbency advantage.

The USO, along with Telstra's historical market present and history, provides the mechanism that positions Telstra to retain this dominance and creates a barrier to entry for competitors.

Uncertainty about the USO levy weighs far more heavily on competitors than it does on Telstra. By their nature, market entrants are considered higher risk investments than incumbents. A negative premium attaches to every risk element that they face, reducing their ability to attract capital. As discussed above, the quantum of the USO levy is immaterial to Telstra's overall revenue, and it is unlikely it share price would react positively or negatively to a change in policy that require it to bear the cost of the USO.

The USO levy also adds to a potential for the USO mechanism to be having a distorting effect on investment that could be working at cross purposes to its intended purpose, and that of other subsidy programs.

Each additional customer added to a network increased the value of the network itself, and one of the original rationales for a USO-type program in economic literature was precisely that it expanded the size and value of the network. However, if the subsidy is paid for by taking resources from the industry itself (either in a traditional tax or in the levy arrangements used in Australia) those are funds that are in effect being diverted from the expansion of the network by the

⁶ <http://www.australianit.news.com.au/story/0,24897,22669158-15306,00.html> Telstra Handout Angers Bush IPs, The Australian, October 30, 2007

addition of commercially viable customers (which is where the industry would invest at least some of these resources) and redistributing it toward customers who would not be added without intervention. The carriers most likely to reinvest the highest proportion of their revenue are new entrants, yet their revenue is diverted to the incumbent, the least likely to invest in expansion.

If these customers are being subsidised repeatedly through different programs, that suggests there is likely to be a net loss in the expansion of the network, and therefore its value and “natural” rate of growth.

That is, the USO could be compounding the very problem it is seeking to alleviate both because it redistributes investment dollar from entrants to the incumbent, and because is likely to be subsidizing end users who are also the beneficiary of other subsidy programs. (see below)

Overlapping Processes and Risk of Inconsistency

In its response to the draft guidelines published by the expert taskforce on a new broadband access network, the CCC recommended that the proponents of new access network projects should not be required to address USO issues in their submissions. This was because there would be overlap and potential inconsistency with this review process.

However, the expert taskforce decided that the guidelines should require proponents to address these issues.

In these circumstances, there is now a high risk of inconsistency and/or overlap between these processes.

Given that bidders are required to address the issue, but that there will be no resolution to these discussions or even insight into the proposals and argument they present until well into 2008, and that the implementation of any proposal will not occur for up to five years, this process cannot incorporate the outcomes of that process at this stage.

Therefore, any attempt at a major redesign of the USO through this process would be at best pointless in that the bulk of the population will be subject to separate arrangements proposed under the expert taskforce process and, at worst, unnecessarily disruptive and/or inconsistent with what might be presented to the expert taskforce.

Changes in Policy Philosophy Requiring Consideration

Any enduring redesign the USO cannot be achieved until the expert taskforce has resolved its requirements. But it can also not be done properly in isolation

from a comprehensive program review to identify overlap in with other Government activity. However, the Department has advised the CCC that a comprehensive consideration of the other programs that have been introduced in recent years that overlap the USO.

The CCC submits that there have been some important changes in the environment in the past three years that must be taken into account in a USO redesign. If this process is unable to consider these issues, it cannot successfully produce an enduring model for the USO.

The most significant of these changes has been the implication inherent in the plethora of broadband subsidy programs introduced by the Federal Government that it believes there is a social obligation to provide some form of broadband service to all Australians.

However, the way that this obligation has been satisfied suggests that the Government does not believe it should be delivered through the USO and that the extended obligation need not create increased USO cost. The preferred approach has been to fund these new services directly through grant programs. Indeed, in many cases carriers other than Telstra are delivering these services on behalf of the Government.

The Government has increasingly built its telecommunications policy around what might be described as the Estens principle, an approach to encouraging the broadest reach of communications technologies outlined in the 2003 RTI (Estens) Report.

This approach relies on maximizing competitive pressures and market opportunities to drive new services to as many consumers as possible. If there are individuals who do not receive access to these services through market driven commercial initiatives, and it is determined as a matter of policy that they should, direct intervention by the Government in the form of grants and subsidies are used to push services to them. While this is sometimes referred to as market failure, it is more accurately considered a market limit.

This limit itself can be extended or reduced through action in the broader policy framework.⁷ For example, the structural separation of the ownership of the network from retail activity would create an incentive for the network owner to encourage greater retail competition in order to maximize the value of the network assets. Under the present vertically integrated network ownership arrangements, the network owner/retailer has an incentive to minimize the entry

⁷ The need to create competitive tension to drive services to regional consumers was recognized in the stated objectives of the Broadband Connect program. It has also been stated by the Minister that the Expert Taskforce will consider issues of industry structure and the impact on competition in its deliberations about the best proposal for a new broadband network.

of new retailers, and this is especially apparent in regional areas where the former monopoly has seen its market power diluted only minimally.

The approach of employing targeted subsidies where services have not emerged as a result of competition has evolved through numerous programs over the past five years in particular. These were targeted initially at the supply end, but increasingly sought to drive from the demand side also. The most important of these programs include the Australian Broadband Guarantee, the HiBIS/Broadband Connect Incentive programs, the Metro Broadband Connect and Metropolitan Blackspots program and the Broadband Connect-funded proposed Opel network.

These programs have been created without any apparent attempt to reconcile the availability of the USO to these same consumers. It is clear from the expansion of broadband funding programs that the Government believes that it now has a further obligation to deliver communications services beyond the standard telephone service, but that these are appropriately delivered through a more modern and transparent mechanism than the legacy USO. The CCC agrees with this reasoning and would strongly oppose an expansion of the USO rather than the transparent, targeted programs approach preferred by the Government.

As a result, however, there is clearly some overlap in the individual end users eligible for support through these subsidies and grant programs and those receiving subsidy through the USO. The extent of this overlap is unknown.

The ABG is particularly problematic in this regard. This program is designed as a last resort guarantee to all Australians that they will be provided with a broadband service at if they desire it.⁸

While on its face, broadband and the voice price and service elements guaranteed through the USO are different, the evolution of communications technology means this is not as clear cut as it once might have been. Indeed, the provision of broadband to an individual consumer under a government subsidy also gives them access to VoIP services from numerous competitive providers. In many cases these VoIP services will be available at prices well below the circuit

⁸ “The Australian Broadband Guarantee will provide universal broadband for all Australians. Anyone unable to gain a reasonable level of broadband service at their principal place of residence or small business will receive a subsidised broadband service. It’s as simple as that.” Ministerial Press Release March 7 2007. [http://www.minister.dcita.gov.au/media/media_releases/\\$162.5_million_for_australian_broadband_guarantee](http://www.minister.dcita.gov.au/media/media_releases/$162.5_million_for_australian_broadband_guarantee)

switched voice products that they would receive through the STS-type specified under the USO. A question that must in this context is whether the existence of the USO in its present form is locking the most disadvantaged consumers into the most expensive fixed line voice technology presently in use.

If these carriers are subject to the USO levy arrangements, it creates a bizarre situation where they are being paid to deliver some services under a social obligation program, and then being levied on the revenue from those subsidized services in order to pay for the delivery of other subsidized services.

This suggests that the USO cost can be quarantined to present services, protecting Telstra from the risk of increasing obligations and cost. This would establish an environment where a further inquiry could lead to transparency of the actual incidence and use of the USO and form the basis for further consideration of the appropriate future design of the program. (as discussed below)

Further, requiring Telstra to absorb the cost of the USO could be regarded as a transitional measure as technology and changes in policy approaches lead to a modernized USO, depending on the outcome of a later, detailed inquiry about the present application of the USO program.

Necessary First Steps toward Reform

It is clear that the USO must be reformed such that it is consistent with the policy approach reflected in the programs implemented to address emerging communications access issues in the past five years.

The first step must be to clarify what is the policy objective being served by the USO, and how this differs from or replicates the objectives being served by the numerous other policy mechanisms, such as those designed to increase access to broadband.

The second element in this reform should be to bring to bear transparency on how the USO is interacting with other programs by conducting a detailed scoping study to identify who is benefiting from the USO.

This requires that Telstra identify the actual services that it claims are the beneficiaries of the USO. The point of this exercise would not be to assess the validity of Telstra's claim that these were loss-making customers⁹ but to determine which of these customers were receiving or eligible for other communications subsidy programs in addition to the USO.

⁹ One exception to this would be customers in new estates who Telstra claim as loss making, but who could be expected to become profitable over time.

It is likely that there is significant “double-dipping” by Telstra and/or the industry generally and multiple programs available to the same end users. This is not an efficient use of public resources. It also is likely that it will emerge that there could be much greater efficacy from a more focused approach to providing subsidies to disadvantaged end users.

It is a matter of the highest importance that overlap and duplication of spending is identified, not only because of the potential for the waste of public funds. As discussed above, programs might be working at cross-purposes.

The final step after clarifying what is the purpose of the USO in the modern telecommunications world would be to bring the USO onto a consistent basis with the other Government initiatives and programs. But this can only follow from a detailed, granular understanding of the scope of the USO. It can also only be done once the Expert Taskforce has recommended how USO issues are to be resolved in a future broadband network.

This would also allow for the future USO to be strictly defined in terms of the services that it represents, and in turn make clear that the Government’s implicit recognition of new obligations around broadband access were being met through other programs. This is crucial to prevent any further duplication by government programs. Overlap could and should be identified and eliminated but this can only occur if it is clear where overlap exists.

Appendix 3

The Use of TSLRIC Costing Methodology

CCC Response to ACCC Draft Determination on Telstra's ULLS Undertaking, January 2009

Introduction

The CCC supports the Commission's draft decision to reject Telstra's ULLS undertaking. In particular, the CCC is generally in agreement with the Commission's clarification of its approach to TSLRIC.

Pricing principles

Under the Trade Practices Act (Part XIC) the Commission can only accept a price undertaking that it considers is reasonable. In assessing reasonableness the Commission must have regard to the following matters:

1. Whether the price promotes the long-term interests of end-users of carriage services or of services supplied by means of carriage services.
2. The legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or provider's investment in facilities used to supply the declared service concerned.
3. The economically efficient investment in the infrastructure by which listed services are supplied.

The long-term interests of end-users is defined be in promoting competition in relevant markets, any-to-any connectivity, and in promoting efficient use and investment in new and existing infrastructure.

In economic terms the sum of the criteria mean that in regulating a monopoly network service such as the local loop (or the ULLS) the Commission must consider whether the price:

- Encourages allocatively efficient use of the network (in this case the local loop).

- Provides fair compensation to the access provider and an incentive to continue to invest in existing (and new) infrastructure.
- Promotes investment in competing local loops when it is efficient.

Promoting efficient use of the existing local loop infrastructure, which by its nature has high fixed costs and low marginal cost, suggests that prices should be set at short run marginal cost. However, such pricing will not allow the local loop owner to recover its fixed costs. As such, prices need to make an allowance for fixed costs. This has been commonly achieved by taking a “long-run” view as to costs and allowing a mark-up for common costs. In actuality, the approach adopted in access pricing amounts to “average cost pricing” with allocative efficiency being sacrificed in favour of the other pricing criteria – in particular to satisfy the legitimate business interests and to promote dynamic efficiency.

Satisfying the legitimate business interest of the local loop provider means that it must be allowed to recover its efficiently incurred costs and get a fair return on its upfront investment in the network. The question of what are its “efficiently incurred costs” creates debate in all access pricing matters and is what drives different cost modelling approaches. Depending on the approach, a model which ensures that the local loop provider recovers its prudently incurred past investments will provide it with incentives to continue to invest in the existing (and new) infrastructure. Creating such an incentive will also promote dynamic efficiency.

Potentially at odds with the first two economic considerations is the consideration of whether the price promotes efficient investment in competing local loops. This consideration is consistent with the legislative criteria to the extent they are interpreted as requiring a price that promotes *infrastructure* competition and promotes efficient investment in *duplicating* existing investment,¹ but it is potentially ‘at odds’ with the other economic criteria (and the very declaration of the local loop service) because it relies on a view that the local loop is not a natural monopoly - that it is efficient to duplicate and that the Commission should create incentives for it to be duplicated.

As noted by the Commission, the adoption of a total service long-run incremental cost (TSLRIC) as its pricing principle has generally been associated with an acceptance of forward-looking cost concepts, and in large part, forward-looking cost considerations have been given significant weight in the Commission’s past decision making. For example, in its Draft Decision, the Commission has noted that:

¹ Both of which are contentious interpretations of the criteria.

One key reason this pricing principle has been adopted in the past has been the ACCC's concern to promote efficient build/buy decisions - in particular, building bypass infrastructure, where efficient. In some respects, TSLRIC+ has been a generous approach to pricing, and has probably overestimated the potential for infrastructure-based competition.

As discussed below, the CCC has significant concerns that the current application of TSLRIC (particularly as embodied in the TEA model) gives too much weight to the last criteria (promoting investment in competing local loops) when it is plainly obvious that the local loop is a natural monopoly network. The focus on build/buy incentives has meant that the other criteria have not been satisfied, in particular prices have unnecessarily diverged more significantly from marginal cost and the local loop owner has received more than fair compensation for access seeker's use of the local loop.

The use of forward-looking TSLRIC

Calculating a forward looking TSLRIC estimate has generally involved regular (sometimes annual) revaluations of the asset base used to provide the unconditioned local loop service (ULLS). As described by the Commission this has generally involved an:

... application of fully forward-looking costs would value all existing assets at the cost of a modern equivalent asset (MEA). A MEA is the lowest cost asset with the latest available and proven technology to provide the same service potential.

The CCC considers that the application of a forward-looking TSLRIC in the TEA model does not satisfy the economic criteria outlined above (and hence does not satisfy the legislative criteria and should be rejected). The reasons for this are outlined below.

Allocative inefficiency

Firstly, the access prices produced by the TEA model do not promote efficiency in resource use because prices diverge significantly from marginal cost. Given the large upfront fixed costs of laying the trenches in the local loop have been incurred many years ago, the marginal cost of using the ULLS is likely to be close to zero now the network is in place. Whilst the CCC accept that short-run marginal cost pricing may not allow for recovery of fixed costs, the Commission should be mindful that all increments above marginal cost in the access price distort consumption decisions.

We note that Telstra, as the local loop owner, does not pay itself the access price paid by access seekers. It therefore only takes into account the marginal cost of using the local loop in its business decision making and retail pricing. This means that for many customers and segments Telstra is able to 'price squeeze' competitors so long as the marginal (access) price of using the local loop is above the marginal cost of its use (which as noted above is close to zero). Whilst Telstra remains vertically integrated, this situation cannot be fully avoided, however the requirement on the Commission to set prices that promote competition should recognise that prices that are further above marginal cost increase the competitive advantage Telstra has as a vertically integrated operator.

Unfair compensation

Theoretically, it is conceivable that a well executed forward-looking TSLRIC could provide a measure of fair compensation for use of the local loop, but this is unlikely, and as outlined below, the forward-looking TSLRIC executed in the TEA model will guarantee more than fair compensation for use of the local loop.

Practically implementing a forward-looking TSLRIC model requires an extraordinary amount of subjective judgement regarding best-in-use technologies, replacement costs, asset lives, asset price trends, achievable efficiencies, cost allocations, and so on and so forth. This makes its use contentious and costly. In its Draft Decision, the Commission indicates that it is:

... aware of the limitations in the application of TSLRIC+ outside its original focus for PSTN assets in that the TSLRIC+ concept revalues the network assets in each regulatory period such that it does not take account of depreciation in the value of the assets. This limitation is particularly apparent in the case of enduring assets such as trenches which are likely to be less susceptible to bypass.

One of the primary difficulties in using a forward-looking TSLRIC model is time consistency. Even in the circumstances where best-in-use technologies and asset values are observable, if errors are made with asset lives or changes are made to depreciation profiles then the fair level of compensation will not be achieved. For example, in the Draft Decision the Commission notes that there is some contention regarding the asset life which should be allowed for copper cable in the TEA model. Telstra as the access provider says the average life is short (say 10 years) such that the calculated price assumes that the copper is replaced, on average, every 10 years even in the circumstance where the copper last longer than 10 years. Anecdotally, it is known that some copper in the Telstra local loop is more than 30 years old and evidence has been provided to the Commission that the average life is at least 15 years. The effect of making an 'error' and using a figure of 10 years for all copper would therefore to compensate Telstra for costs it is not incurring or not truly expecting to occur.

Similarly, the Draft Decision recognises that there is some contention as to the appropriate depreciation profile for recovery of the assets which make up the local loop. Telstra is seeking a change in the past approach to depreciation – it is seeking a flat annuity when previously a tilted annuity has been used – which has the effect of increasing the price of the ULLS. In order for a forward-looking TSLRIC to achieve fair compensation the depreciation profile cannot easily be changed. That is, once a depreciation path has been set only adjustments to the depreciation path which ensure that the expected cash flows over the life of the asset equal the invested value of the network will achieve the same level of compensation. This is not easy to achieve. If we imagine we begin with a \$100 asset and started depreciating it over its

5 year life using straight line depreciation (equal to \$20 in each and every each year). Now imagine that in a subsequent year we decide to adopt an alternative profile such that the annual depreciation allowance increases. This will inevitably lead to a different level of compensation for the initial investment. The CCC notes that this is precisely the effect of Telstra's proposed change – midstream Telstra is asking the Commission to accept an increase in annual depreciation allowance by moving from a tilted annuity to a flat annuity.

A price that gives fair compensation also plainly requires that an access provider does not get compensated for costs it does not incur. Compensation for costs not incurred can happen in at least two ways under a forward-looking TSLRIC approach. First, it will happen if a replacement cost is included in the asset valuation for costs that the access provider has not incurred. The classic example of this in the TEA model is the inclusion of costs of re-digging trenches that Telstra was given access to for free.

Second, over compensation will happen if the replacement asset values used in the model are not equal to the expected cost of replacing the asset. As above, this can occur if the asset life is mis-estimated, or if the asset price trends (the forecast of change in asset prices) assumed in the model are incorrect, or if the replacement cost of the asset does not accurately reflect the replacement cost of an asset with identical service potential.

Inefficient build/buy incentives

The primary objective of adopting a forward-looking TSLRIC approach to valuing the copper local loop is to promote efficient build/versus buy incentives. Telstra's expert,

Professor Harris, endorses this view and argues that the TEA model provides the build/buy incentive. Professor Harris notes:

Given its intended use in pricing ULLS, it is necessary to ask what it would cost a new facilities-based entrant to replace the CAN when working through the theoretical TSLRIC+ construct. A new entrant would have to build its network in the environment as it exists today, with buildings, highways, streets, yards, rivers, mountains, and other man-made and natural obstacles in place. The entrant would have to use the construction techniques or placement methods that are needed to build around or under these obstacles and would not have the luxury of installing its network in unobstructed "green field conditions." In addition, if the new entrant were building a loop network today designed to serve all of the existing premises (an assumption that is consistent with TSLRIC+), it would operate in a world with rights-of-way in their current positions and paths and face limited opportunity to share the costs of placing facilities with other network service providers.

The CCC notes that experts such as the Competition Economists Group (CEG) have taken a contrary view, noting that this rationale is of "dubious merit" because of the fact that the local loop is a natural monopoly and therefore is unlikely to be replicated by another copper local loop operator. In a submission for Optus in 2003, Dr Hird of CEG noted that:

... the justification for using TSLRIC (or TSLRIC+) is not related to setting efficient build/buy decisions but is best justified on the grounds of providing for dynamic efficiency in the incumbent's future investments

The idea that a new entrant who has the option to build an optimised deployment would choose the same technology as used by Telstra is difficult to sustain in either a theoretical or practical sense. For this reason the CCC does not consider the TEA model to be a credible method for estimating asset values and is not even likely to achieve the (build/buy) objective it purports as its basis.

The CCC considers that even in the event that an operator did decide to bypass the local loop it would not likely use copper. A new local loop operator might use wireless or cable network as the basis of its entry. In fact, if a new operator were to re-dig the trenches, as envisaged by Telstra and its experts, it would lay fibre to the home rather than copper. Such a network would provide a significantly higher quality of service than is provided by the existing copper loop but cost about the same given the vast majority of the cost of the network is in trenching and labour costs and the cost difference between copper and optical fibre cabling is not significant (particularly given the lower operating costs of a fibre optic network).

As a result, the price a new entrant would be willing to pay for a "low quality" copper service would be much less than the cost of replacing the cables in existing trenches because if they had to pay that cost they, and their customers, would be better off building rather than buying and getting a "high quality" fibre service. Therefore, if the objective was to provide appropriate incentives for build versus buy, the unadjusted (for quality) price produced by the TEA model will over-estimate the price required to encourage efficient bypass of the local loop.

The Commission's reasoning

In its Draft Decision the Commission proposes what it describes as a "pragmatic implementation of TSLRIC". This is one that does not adopt a forward-looking cost concept in all aspects of its decision. In particular, the Commission points to

“recognition of actual circumstances” as a reason to diverge from a purely forward-looking TSLRIC approach. It notes in particular its:

- Adoption of a scorched node approach to TSLRIC in which “key features” of the network (eg., pillars and exchange locations) are “kept constant”.
- Costing of technologies which are in common use in Australia rather than the best available technologies that would be selected by a new entrant.
- Assumption that many assets in the network are not “re-optimised”.

The CCC considers that the Commission’s pragmatic approach to TSLRIC is reasonable in the circumstances. However, we consider that it is important to recognise that each of these “pragmatic” decisions effectively protects Telstra’s investment decisions from any assessment as to the efficiency of that decision. What does this mean? It means that Commission is effectively ruling that Telstra’s past decisions were prudent and its assets should not be stranded – as a result Telstra is guaranteed a return on those past investments.

Whilst the decision to regard some of Telstra’s investments as prudent may be reasonable it is not reasonable to cost the parts of the network that are protected from optimisation on a forward-looking basis such that the price of those network elements ends up over-recovering what Telstra spent on them.

Such an outcome would be patently ridiculous and obviously inconsistent with the legislative criteria. By analogy, it would be equivalent to contracting with a builder to build you a house and then coming back to you five years after it is built and paid for and saying “that house would cost twice as much to build today, you have to pay me more”, or in Telstra’s language, “that trench would have cost twice as much to build today, you have to pay me more”. As a monopoly network owner Telstra is not exposed to a competitive market in which entry is likely - it does not face the downside risk of entry due to reducing input prices (or the upside risk that entry would be deterred by increasing input prices), it should therefore not be compensated for such risks.

In general, the CCC considers that the Commission has reasonably applied a pragmatic approach to assessing the TEA model. Following are some specific areas of agreement and disagreement with the Commission’s Draft Decision.

On **technology choice** the Draft Decision says that:

“The ACCC considers that, although it is unlikely that a hypothetical entrant today would build a copper network, there is still a need to determine a price for the ULLS. The ACCC’s view is that, while a pure implementation of TSLRIC would involve using technology such as wireless or optical fibre, a pragmatic implementation of TSLRIC methodology involves determining ULLS pricing based on a copper network”

The CCC disagrees with this position for the reasons outline above. It is not necessary for the ACCC to only consider the TSLRIC cost of copper technologies when others might deliver the same (or better) service potential than the copper network. By definition, to adopt a forward-looking costing is to mimic the decisions of a new entrant. In considering a build/buy decision the new entrant will not in any way restrict itself to copper, it will consider the range of technologies capable of delivering the same downstream services to it customers.

On **trench re-digging** costs the Draft Decision says that:

“the ACCC believes that the inclusion of trenching costs, where they have not been incurred by Telstra, will lead to access prices which discriminate between access seekers and access providers which is not in the LTIE. Access prices should be set so as to allow more efficient sources of supply to displace less efficient sources of supply in dependent markets. In this regard, if an incumbent is allowed to recoup surface barrier costs that it does not incur, it will have little incentive to efficiently invest in

infrastructure. Further, at an inflated access price, access seekers will look to build and not buy, when it may be more efficient to buy.”

The CCC agrees with this for the reasons outlined above.

On **new estate trenching costs** the Draft Decision says that:

The ACCC considers that, when applying the TSLRIC framework in a practical sense, forward looking network costs need to reflect the realities of network deployment and that it is not possible for the CAN to be constructed in one period (or instantaneously). The ACCC view is that network construction would generally be planned a significant time in advance and would most likely occur in conjunction with other operators and utility providers resulting in the use of open trenches in new estates at no cost to Telstra. The ACCC considers that based on a pragmatic application of TSLRIC, it is appropriate to maintain its position that the best available proxy for trench sharing in new estates is the cumulative (historic) trench sharing measure. In this regard the ACCC considers that a trenching sharing value of between 13-17 per cent approximates cumulative trench sharing potential in new estates

The CCC agrees with this conclusion but disagrees with the reasoning. Like the analysis for trench re-digging costs these are cost that Telstra **has never incurred therefore it is not reasonable that it should be compensated for those costs.** Moreover the CCC considers the Commission should go one (logical) step further and conclude that none of the trenches in the model should be valued on a forward-looking (current) cost basis as these are network elements which are being protected from optimisation.

On **equity issuance costs** the Draft Decision says:

“The ACCC accepts that equity issuance costs may be incurred by an entity when it raises equity capital. As such, when an entity incurs equity raising costs it may be appropriate for the entity to be able to recover these costs. However, the ACCC considers that equity raising costs should be recovered as a cash flow (operating cost) allowance and not in the WACC.

In addition, the ACCC notes that Telstra has not actually raised equity capital. The ACCC does not consider it is reasonable to compensate Telstra for costs that it did not incur. Therefore, the ACCC does not consider Telstra’s argument for an allowance for equity raising costs in the WACC will lead to fair estimate of Telstra’s vanilla and pre tax WACCs.”

The CCC agrees with this conclusion and the reasoning.

On **tilted annuities** the Draft Decision says that:

“The ACCC considers that the application of a tilt to regulated cash flows under the TSLRIC regime is appropriate for fair compensation because assets are re-valued periodically by the regulator to reflect a current hypothetically efficient network in each regulatory period. The ACCC considers that if a zero tilt is applied then Telstra may receive an abnormal return when its assets are re-valued upwards in future regulatory periods in response to price trends. In particular, Telstra will receive ex-ante over compensation due to the expectation of this revaluation. This view is consistent with ACCC’s approach in developing ULLS indicative prices”

The CCC agrees with this conclusion and the reasoning and emphasises that the importance of time consistency is driven by the continued revaluations of the asset base.

International regulator’s approach

The CCC has conducted a brief survey of key economic regulators around the world (and in Australia) and notes that there is strong support for the Commission’s evolving position.

We note that Ofcom in the UK has now specifically ruled out adopting a hypothetical model for the following reasons:

“... basing the value of BT’s network on what somebody might spend if they were to build a brand new network today as opposed to simply replacing what BT has. Responses from those companies which do not have their own network were in favour of such an approach as it would lead to the result that might be expected if an effective competitor to BT were to build their own network. In contrast, those companies which do have their own network – BT and the cable companies – did not agree with this approach. Ofcom agrees that such an approach is not appropriate as there is a great deal of subjectivity in the modelling and it is important that the model is right if it is to be used. Also, the use of such a model could require Ofcom to become intrusively involved in BT’s internal network planning and investment decisions. It is Ofcom’s view that with the information available today it is

² Ofcom, Valuing copper access, Final Statement, 18 August 2005.

<http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/statement.pdf>

³ Telstra Corporation Ltd (No 3) [2007] ACompT 3 (17 May 2007) at [380] and [382]

<http://www.austlii.edu.au/au/cases/cth/ACompT/2007/3.html>

⁴ FCC, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996* CC Docket No. 96-98, First Report and Order, 8 August 1996, paragraph 685.

*better to base costs on something real, i.e. BT's network, as a more objective way of determining what the replacement cost would be."*²

The view that a new entrant would not adopt the same technology as Telstra is consistent with the Australian Competition Tribunal's view of forward-looking (current) costing (we note that the TEA model is, in essence, just a somewhat sophisticated, current cost accounting calculation for the current Telstra network):³

"We do not consider that the current cost of building an existing CAN is necessarily likely to be an accurate guide to the forward-looking TSLRIC of providing the ULLS. It is not clear to us that an access provider building a network today would choose the same assets as it uses in its current network. We do not accept that Telstra's current cost estimate of providing the ULLS constitutes sufficient evidence as to the likely TSLRIC of providing the ULLS, nor, therefore, to the reasonableness of Telstra's ULLS access charge for the periods covered by the undertakings."

The FCC has determined that a scorch node network provides an appropriate benchmark because a model of which satisfies both fair compensation and build/buy incentives without loading in cost that are not incurred by the network owner. The FCC notes that:⁴

"... forward looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants ... this approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than".

Alternatively other regulators have "done away with TSLRIC" or at least regular revaluation of the asset base, for example, Ofcom decided:

"... to create a regulatory asset value, or RAV, to represent the remaining value of the pre-1997 copper access network assets rather than continuing to value those assets at their current cost. The value of the RAV is set to equal the closing historical cost accounting value for the pre 1 August 1997 assets for the 2004/5 financial year and its value will be increased each year by the Retail Price Index to ensure it is not eroded by inflation. Over time

⁵ Ofcom, *Valuing copper access*, Final statement, 18 August 2005, page 2.

<http://www.ofcom.org.uk/consult/condocs/copper/value2/statement/statement.pdf>

*the RAV will gradually disappear as the pre-1997 assets are gradually replaced with new ones."*⁵

That is Ofcom has decided to no longer value the copper local loop assets on a full current cost accounting basis. Instead it will establish an historic cost approach to assets valued prior to 1 August 19997 and to value all assets installed after this date on a current cost accounting basis. Ofcom indicate that this change reflects its view that it no longer considers there to be a prospect of entry in the local loop and hence the primary objective of the valuation is to protect consumers where it was previously to send appropriate build/buy signals to new entrants.