Submission in response to ACCC
Discussion Paper

Extension and Variation of Existing Fixed Line Services Final Access Determination

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Section 1. Executive Summary

1.1 The Australian Competition and Consumer Commission (ACCC) has taken a decision to extend the existing fixed line services Final Access Determination (FAD). The current consultation only considers proposed variations to the FAD to include the internal interconnection cable (IIC) and pricing of Wholesale Line Rental (WLR) and Local Call Service (LCS) in CBD areas. Whilst Optus' submission comments on the proposed variations, it also raises concerns with the ACCC's decision to extend the FAD without consultation.

1.2 Telstra received $693 million during 2012-13 and the first half of 2013-14 in NBN payments for access to fixed line assets that are also used to supply declared services. This additional revenue has not been taken into account when setting access charges in the 2011 fixed line services FAD or the proposed extension.

1.3 Consequently, Telstra has been able to recover costs from both access seekers and NBN Co. Optus estimates that Telstra is likely to receive around $200 million by end of 2013-14 in excess access revenue as a result of the payments form NBN Co not being taken into account. The windfall gain will grow without appropriate variations to the extended FAD.

1.4 Such a large windfall gain does not promote the long term interest of end-users (LTIE). It not only inhibits competition in the current PSTN-based market, but it provides a significant cash flow advantage that Telstra can use, and has used, to strengthen its position in related communications markets (such as mobiles) and to ensure it remains the dominant player in the future NBN-based market.

1.5 Optus submits that access seekers and end-users should not be penalised because of the decision to extend the FAD. At a minimum, the access charges under the extended FAD should be varied to reflect the NBN payments received by Telstra for relevant PSTN assets. Optus estimates that access prices could fall by up to 10-15% if NBN payments are factored into the FAD.

1.6 Optus believes strongly that the ACCC's decision to extend the 2011 FAD should be revisited. Extending the current FAD is likely to have negative implications for access seekers and end-users. Most immediately, it locks access seekers into regulated rates that were determined three years ago and which did not take into account NBN payments. The longer the new FAD is delayed the greater the benefit to Telstra and the greater loss to the end-users and access seekers. Optus is further concerned by the open-ended nature of the extension, which provides incentives for Telstra to further delay and game the process.

1.7 The purpose of Part XIC is to promote the LTIE. Reducing access charges to reflect the cost of providing the service is consistent with the legitimate interest of access providers and reflects the direct cost of providing the service.

Section 2. Extending the existing FAD

2.1 Optus acknowledges the practical need to extend the fixed line services FAD given the current timeframe. However, the current situation could have, and should have, been avoided. Further, the decision to extend the existing FAD rather than rely on other approaches will limit the ability to vary access prices to promote the LTIE.

2.2 The decision to extend appears to have been taken without consultation with industry — and while Part XIC does not require consultation, regulatory best practice does. Optus is concerned that access seekers and end-users may be prejudiced as a result of the ACCC extending the current FAD.

2.3 The delay in setting anew access determination could have negative implications for access seekers and end-users. Most immediately, it locks access seekers into regulated rates that were determined three years ago and which did not take into account NBN payments. The longer the new FAD is delayed the greater the benefit to Telstra and the greater loss to the end-users and access seekers. Optus is further concerned by the open-ended nature of the extension, which provides incentives for Telstra to further delay and game the process.

Other methods should have been considered

2.4 Optus submits that the ACCC should have considered alternative arrangements to extending the FAD, such as use of Interim Access Determinations (IAD). The reasons for the extension of the expiry date for the existing FADs for fixed line and wholesale ADSL is outlined in section 5 of the Discussion Paper. The ACCC concludes that the circumstances for extension of the FAD set out in s.152BCF(10) were satisfied, noting that:

> *Extending the expiry date of the existing FADs will also provide regulatory certainty and consistency for access providers and access seekers until new FADs are made and come into force.*[1]

2.5 While regulatory certainty is one relevant consideration, the ultimate criteria is whether the decision best promotes the LTIE. The ACCC should have analysed whether there were other options that better promotes the LTIE. Optus submits that the ACCC could have considered alternative options that provided the regulatory certainty that the extension is intended to provide yet enabled sufficient flexibility to address any significant pricing implications that may arise during the upcoming new FAD inquiry.

2.6 One approach would have been to commence the FAD inquiry at an earlier date so that a new FAD could have been put in place by 30 June 2014.

2.7 An alternative option would be to make a short extension to the FAD and to then issue an IAD. The 2011 FAD, which expires on the 30 June 2014, could be extended to 31 July, the date of expiry for the existing fixed line. The new fixed line declarations would then commence on 1 August 2014, and while it is unlikely that a new FAD for the declared services will have been finalised before this commencement date, the ACCC could have issued an IAD which extended the existing FAD terms until the conclusion of the upcoming FAD inquiry.

2.8 The benefits of issuing an IAD would be two-fold:

[1] ACCC, Fixed Services Review, Extension of existing fixed line services and wholesale ADSL final access determinations and Inquiry into varying the WLR, LCS, ULLS and LSS final access determinations, Discussion Paper, April 2014, p.12

(a) First, an IAD would provide regulatory certainty and ensure there is no significant change in access prices while the new FAD inquiry is undertaken.

(b) Second, setting an IAD at this stage would provide the ACCC with the flexibility to assess access prices during the FAD inquiry, and where it is determined that prices need to be varied, it is possible to backdate the FAD commencement date to align with the start of the declaration period.

2.9 Importantly, the approach that has been taken may result in the over-recovery of access charges for the duration of the extension period. Additionally, it has also removed the ACCC's flexibility to address any access seeker concerns, as well as to adjust prices in the extension period.

2.10 It is not clear whether the ACCC would roll-over any over-recovery by Telstra into a new FAD. As a result, Optus is concerned that windfall gains obtained during the extension period would not be recovered. This does not promote competition or the interests of end-users.

Section 3. Varying the extended FAD

3.1 The ACCC proposes to vary the existing fixed line FAD to give effect to:

(a) Removing the CBD WLR and LCS exemptions; and

(b) Include the IIC decision.

3.2 Optus supports these changes. However, the ACCC should go further and adjust the ULLS, WLR, WADSL, LSS, LCS and PSTN OTA rates to take into account the payments Telstra has received, and will receive during the extension period, for NBN-related access.

3.3 In addition, Optus submits that the FAD should also be adjusted to take into account the significant revenues Telstra has received and will continue to receive from the NBN for use of fixed line assets. If these revenues are not accounted for, there is a significant risk of over recovery by Telstra since access charges will be set at levels higher than would otherwise be the case.

Proposed variations to give effect to WLR and LCS

3.4 Amending the extended FAD to remove the CBD WLR and LCS exemptions will bring the FAD into alignment with existing FAD terms in non-CBD areas. Practically, there is currently no differentiation in the non-price terms and conditions for these services. The key impact of this change will be to ensure that the price terms are uniform across all geographic areas.

3.5 Competition in relevant retail markets already exists on a nationally averaged basis. The alignment of wholesale access charges would therefore continue to allow access seekers to compete on merit in relevant markets.

3.6 The issue however remains that by simply extending the existing FAD terms for non-CBD areas to also apply in CBD areas does not address access seeker concerns raised in their arguments for the repeal of the WLR and LCS exemptions.

3.7 While the ACCC reaffirms it is view that "*it is reasonable that the price terms that currently apply to WLR service and LCS in non-CBD areas should also apply to WLR service and LCS supplied in CBD areas*"[2] this does not take into account the over-recovery of access charges access seekers were faced with during the existing FAD period.

Proposed variations to give effect to IIC

3.8 Optus welcomes the recognition of the IIC service as an ancillary service required for the supply of ULLS and LSS. However, Optus is concerned by the ACCC's proposed approach to set IIC charges based on the IIC charge set in the final arbitral determinations between Telstra a number of access seekers in 2012. It should be recognised that Optus was not party to the access seekers, hence was not privy to the information canvassed during the access dispute.

3.9 As such, Optus is unable to comment on the proposed IIC charge set out in the FAD variation as it has not been party to the cost modelling or any other cost information that was used to determine final IIC charge during the arbitral proceedings.

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[2] ACCC, Fixed Services Review, Extension of existing fixed line services and wholesale ADSL final access determinations and Inquiry into varying the WLR, LCS, ULLS and LSS final access determinations, Discussion Paper, April 2014, p.16

3.10 In particular, it is unclear how all IIC charges have been taken into account. For example, the proposed FAD rate only refers to a monthly access charge for IIC on a per cable pair basis which raises some ambiguity on the translation of this rate to existing services. **[CiC]**

3.11 **[CiC]**

3.12 Prior to imposing the rate upon all access seekers, the ACCC should engage in a proper industry consultation, including a broader assessment of the costs of IIC. Optus anticipates that this should occur during the development of the next fixed line services FAD.

Estimating impact of NBN payments

3.13 Telstra and NBN Co signed a Definitive Agreement in 2011 outlining payments to be made by NBN Co and Government to Telstra for access to and use of Telstra fixed line infrastructure. These payments cover many of the same assets that are used to provide the fixed line declared services. The 2011 FAD did not take these payments into account. The ACCC stated:

> *The ACCC expects that the uncertainties currently hindering the ACCC's assessment of the impacts of the NBN will be resolved well before the next regulatory period.*[3]

3.14 The proposed variation to the extended FAD does not address the impact of NBN payments to Telstra for the lease and use of the same assets that are used to supply declared fixed line services, notwithstanding that the level of payments received are publicly disclosed in financial reports.

3.15 Optus submits that there is more than sufficient information regarding the level of payments that are to be, and have been, received by Telstra. While there is some uncertainty as to the form and timing of any new agreement between NBN Co and Telstra as a result of the change from FTTP to FTTx, Telstra has stated publicly that it expects to remain whole — i.e. to receive the same net present value. More pertinent is that Telstra is currently receiving payments under the existing agreement. Since financial year 2012-13 and including first half of 2013-14, Telstra has received $693 million in NBN payments — growing at 67% year-on-year.[4] None of this has been factored into access fees for fixed line services.

3.16 The $693 million in NBN payments should be offset against the revenue required from fixed line services access seekers. If this revenue is not recognised then there is a real risk of Telstra over-recovering costs for assets that are used by both NBN Co and access seekers.

<u>What are the NBN payments</u>

3.17 The announcement of the Definitive Agreement expressed the payments as $11 billion in post-tax net present value (NPV) terms in 2010 value. The post-tax NPV value increases if looked at in recent nominal valuation. For instance analysts estimate it is equivalent to $14 billion NPV in 2013 terms. Moreover, this analysis does not take into account different timings of payments and liabilities. It could be substantially higher if access payments are brought forward due to earlier roll-out of NBN under a FTTx model.

3.18 Telstra will provide NBN Co with large scale access to certain infrastructure (dark fibre, exchange space, lead-in conduits and ducts) at prices based on committed large volume levels of usage and availability. The term of the infrastructure agreement (ISA) will be between 35 and 40 years from commencement, plus two 10 year options to extend to be exercised by NBN Co. In return, Telstra will receive infrastructure payments of approximately

[3] ACCC, Fixed Services Review, Extension of existing fixed line services and wholesale ADSL final access determinations and Inquiry into varying the WLR, LCS, ULLS and LSS final access determinations, Discussion Paper, April 2014, p.33
[4] NBN payments for 2012-13 and 1H 2013-14. Telstra Results Presentation, 1HFY2014, p.10, & FY2013, p.9

$5 billion (post-tax NPV in 2010) for leasing access to NBN Co to be paid over an average 30 year period. Telstra will also receive $4 billion (post-tax NPV in 2010) for disconnection payments and the sale of lead-in conduits over a 10 year period. Additionally, Telstra will retain ownership of all infrastructure assets, with the exception of lead-in conduits which will be transferred to NBN Co upon use. In summary:

> *Under the agreement, Telstra will provide much of the infrastructure required to build the network including:*
>
> - *Lead-in conduits through which the NBN fibre will be connected to each premise;*
> - *Underground ducts and pits through which the NBN fibre will run;*
> - *Dark fibre; and*
> - *Rack spaces in Telstra exchanges.*[5]

3.19 The nominal cash flow value greatly exceeds the historic-value post-tax NPV approach — and it is nominal cash flow that should be included in the FLSM. The original 2011 analysis showed that Telstra expected to receive around $3.3 billion from NBN Co in revenue for fixed-line assets during the period of this declaration (2014-2019).[6] More recent analyst reports show that Telstra could receive around $8 billion in nominal terms over the lifetime of the next FAD.[7] The latest financial results show that Telstra received $399 million in NBN payments for FY2013 and $294 million in 1H FY2014. This is expected to increase over the next few years as NBN Co connects more premises. There have been reports that Goldman Sachs calculated NBN Co's liability to Telstra at around $98 billion in nominal pre-tax dollars over 50 years — rising from $400 million in this financial year to $1 billion in FY2019 (the last year of the new FAD).[8]

<u>Inclusion within the FLSM</u>

3.20 The ACCC has been supplied with two expert economic reports from NERA and Frontier Economics, both arguing that the inclusion of NBN payments within the FLSM promotes the LTIE.[9] These reports provide justification, and recommend possible methods, to incorporate payments into the FLSM.

3.21 The FLSM allocates costs on a cost causation method — allocating costs directly to assets that cause the cost, and indirectly allocated across a range of common assets where direct allocation is not possible. Inclusion of NBN payments should also follow this principle. NERA recommended that the ACCC adopt a revenue-based method, stating:

> *In our opinion, the LTIE is best served by the methodology that delivers the lowest wholesale access price, providing this would lead to a material increase in the utilisation of the CAN during the transition to the NBN without imposing significant capacity-related costs upon the access provider. On the facts available to us, adopting the revenue approach is more likely to be consistent with the LTIE than the alternative, cost*

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[5] NBN Co, "NBN Co and Telstra sign binding Definitive Agreements," Media Release, 23 June 2011

[6] Telstra, *Telstra's participation in the roll-out of the National Broadband Network*, Explanatory Memorandum for the resolution under item 2 at the annual general meeting on 19 October 2011

[7] Optus, 2013, Submission in response to the ACCC Discussion Paper on the Fixed Line Services Declaration

[8] CommsDay, 2014, http://www.commsday.com/commsday-australasia/exclusive-nbn-co-payments-to-telstra-could-total-98-billion-confidential-advice

[9] http://www.accc.gov.au/regulated-infrastructure/communications/fixed-line-services/fixed-line-services-fad-inquiry-2013/receipt-of-preliminary-submissions

approach, since the latter may have the effect of allowing Telstra to earn a return that is greater than its efficient costs, including a normal return on the CAN.[10]

3.22 Optus has estimated the likely impact on the cost-based access rates for 2012-13 and 2013-14 using actual Telstra payment data. Following NERA's advice, Optus has adopted a revenue adjustment model. Given that there is insufficient information to make accurate cost based changes, and the likelihood that NBN payments are in excess of the depreciated value of the assets, this approach is reasonable and best promotes the LTIE.

3.23 The payments are offset against the annual revenue requirement for specific asset classes, or asset class group as per cost causation principles. The following payment are included:

(a) **Infrastructure Services Agreement** (ISA): payments to Telstra for long-term access to and use of network infrastructure. This includes: dark fibre links, rack spaces in exchanges, ducts and associated duct infrastructure. The payments relate to the use of a range of asset classes in both the Customer Access Network (CAN) Asset Class and Core Asset Class. This revenue is offset against both asset classes. ISA payments amounted to $89 million in 2012-13, and the first half payment of $139 million is doubled to estimate the 2013-14 payment of $278 million. Given the significant growth in this payment, this is a conservative assumption.

(b) **Subscriber Agreements** (PSAA): payments to compensate Telstra for migrating subscribers off its network and onto the NBN. This includes the decommissioning of the copper network. This revenue is offset against the copper cables asset class. This amounted to $7 million in 2012-13, and the first half payment is doubled to estimate the 2013-14 payment of $38 million. Given the significant growth in this payment, this is a conservative assumption.

(c) **TUSMA Agreement**: payments to supply the USO obligations. The networks costs of complying with the USO are included within the FLSM. The majority of USO related costs relate to assets within the CAN Asset Class. TUSMA payments are therefore allocated to the CAN Asset Class. This amounted to $124 million in 2012-13, and the first half payment is doubled to estimate the 2013-14 payment of $154 million. Optus notes that the USO payments to Telstra have, and will increase, significantly under the TUSMA contract without any commensurate change in obligations or costs.

(d) **Retraining Payments**: payments to compensate Telstra for expenditure related to staff training for NBN workers, or Telstra workers made redundant due to roll-out of NBN. The cost of complying with this could be included within Telstra's operational expenditure within the FLSM. These payments are offset against the total direct and indirect opex figure in the FLSM.[11] This amounted to $11 million in 2012-13, and the first half payment is doubled to estimate the 2013-14 payment of $14 million.

(e) **Information Campaign and Migration Deed**: this reflects 'residual' payments from the Commonwealth relating to the 'valuation of the proposal' and migration to NBN. This government payment is for additional costs incurred relating to NBN transition not covered elsewhere. These costs could be included within opex under the FLSM. These payments are offset against the total direct and indirect opex figure in the FLSM.[12] This amounted to $168 million in 2012-13, and the first half payment is doubled to estimate the 2013-14 payment of $104 million.

[10] NERA, 2014, *Payments to Telstra for Lease/Purchase of Fixed-Line Assets: A report for Optus*, March 2014, p.i
[11] "F. OPEX Allocation"
[12] "F. OPEX Allocation"

3.24 Inclusion of NBN payments within the FLSM for the past two years shows that the impact is material. The cost to provide access for fixed line services is around 10-15% less per connection than without NBN payments. As a result, access seekers and end-users are paying above the efficient level and Telstra is earning substantial monopoly rents. Such an outcome does not promote the LTIE.

3.25 Optus estimates — using public Telstra data — that Telstra will receive between $150 to $217 million windfall during 2012-13 and 2013-14[13] as a result of regulated access charges not reflecting the payments from NBN Co.[14] This is on top of the $693 million received from NBN Co as at first half 2013-14. This over recovery of costs will grow significantly as NBN demand grows unless access charges are adjusted to reflect the NBN payments to Telstra.

3.26 Allowing the dominant provider of communications to double dip in this way does not promote the LTIE. It not only undermines competition in the current PSTN-based market, but it provides a significant cash flow advantage that Telstra can, and has, used to strengthen its dominance in related markets (such as mobile) and to ensure it remains the dominant player in the future NBN-based market.

[13] 2013-14 values reflect the growth rate in the first half results applied to end of year figures.
[14] Lower bound excludes retraining payments and information campaign and migration deed payments. It is not clear whether the costs which are being compensated are included within the FLSM.