Cost allocation and declining demand for fixed line telecommunications services: comments on submissions and the ACCC proposal paper

Report for Gilbert + Tobin

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1. Introduction and overview

1.1 Our scope

Incenta Economic Consulting (Incenta) has been engaged by Gilbert + Tobin on behalf of Telstra to review and provide comments on certain submissions submitted to the Australian Competition and Consumer Commission (ACCC) as part of its inquiry into final access determinations for fixed line services.[1] We have also been asked to comment on the ACCC's proposed approach to declining demand that it articulated in its recent Position Statement on the Telstra and NBN Co. arrangements.[2]

1.2 Authorship

This report has been prepared by Jeffrey John Balchin, Managing Director of Incenta Economic Consulting. I have 20 years experience in relation to economic regulation across a range of infrastructure sectors, which has included advising regulators, governments, asset owners and major customers. This has included many years of experience with the design and implementation of the "building block" model of regulation in Australia and New Zealand. My curriculum vitae was attached to my earlier report on this issue.[3]

I have been assisted in preparing this report by Scott Stacey; however, I take responsibility for all of the report's contents.

I have read, understood and have complied with the Federal Court's guidelines for expert witnesses.

1.3 Summary of responses to submissions

This section sets out the key points that are made in this report.

1.3.1 Cost allocation

Meaning of the fixed principles for cost allocation

- Submissions argued that an argument exists that the ACCC has in fact applied the requirement to allocate costs based on "relative use", or that there is at least ambiguity in the fixed principle in relation to cost allocation that leaves the ACCC with some flexibility.
- I disagree with these arguments, or at least do not agree that they have the argued implication.
- Turning to the first argument, as I explained in my earlier report, the ACCC's partial cost allocation approach has the effect of either:

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1 See: http://www.accc.gov.au/regulated-infrastructure/communications/fixed-line-services/fixed-line-services-fad-inquiry-2013/consultation-on-primary-prices

2 ACCC, 'Public Inquiry into final access determinations for fixed line services – primary price terms, Position statement on the treatment of the Telstra-NBN Co arrangements for regulated pricing', October 2014.

3 Incenta Economic Consulting, 2014, Cost allocation for fixed line services, October.

- *Interpretation 1*: Allocating an amount of cost based upon relative use, but where the cost that is allocated between services has not been calculated in compliance with the fixed principles that govern the calculation of the revenue requirement, or
- *Interpretation 2*: Allocating an amount of cost that has been calculated in compliance with the fixed principles between services, in which case the amount allocated to unregulated services in greater than in accordance with their relative use (and so does not comply with the cost allocation fixed principle).

- While under Interpretation 1 the cost allocation principle could be said to be met (which is the argument in submissions), the fixed principles in total are not met.
- Turning to the second argument, the "flexibility" to which attention is drawn is the ability for the ACCC to choose how wide to define "other services" when allocating costs. However, to the extent this provides any flexibility:
  - the flexibility that exists is to choose not to allocate cost to some of the unregulated services, which may be justified if the use of the shared assets by those services is immaterial, but
  - the effect of this would be to increase the proportion of shared costs that are allocated to the regulated services (as the denominator used to calculate "relative use" gets smaller), meaning that
  - if this flexibility were exercised, then regulated charges would increase, which is contrary to what seemed to be implied in submissions.

Consistency with the objects cause of Part XIC

Promotion of competition

- Submissions argued that allowing Telstra to increase its access prices would either be neutral towards the level of competition in retail telecommunications markets, or would reduce the level of competition in those markets.
- In my earlier report, I concluded that the level of Telstra's access prices would be approximately neutral towards the level of competition in retail markets, and remain of this view.[4] This is consistent with some of the views expressed in submissions.

[4] To be clear, in my earlier report I observed that two assumptions could be made about the outcomes for cost recovery under the "partially allocated cost" method, which were that
(i) Telstra would fail to recover its total cost, and there would be little impact on competition, or
(ii) Telstra would succeed in recovering its total cost by raising its prices in other markets (retail fixed line prices, mobile etc.). This would then have the effect of reducing the competitive constraint that Telstra provides in those other markets. Under this assumption, if Telstra's cost allocation method were instead applied, then there would be an improvement in competition in those other markets.
While I favour the first of these assumptions, the important implication is that it cannot be asserted that Telstra is able to "top up" its cost recovery by raising prices in other telecommunications markets without acknowledging that increasing prices in that manner will also harm competition on those other markets.

- The effect of Telstra's proposed approach to cost allocation is to derive access prices that accurately reflect the cost of providing the relevant services. It would be extraordinary if access prices calculated in such a manner were somehow incompatible with competition in related markets. Rather, Telstra's proposal can be said to be consistent with efficient or sustainable competition, in that the competition created in the related markets will be consistent with the continued provision of the fixed line services, which is not an outcome that would be created if the building block approach were back-engineered to generate a predetermined (non-cost reflective) price.

- The more relevant issue for competition in related markets is how Telstra's retail prices relate to the efficient, cost reflective access prices. This is a concern about retail pricing behaviour and should not – and indeed cannot – be remedied through manipulating access prices. Rather, such matters can be investigated (and, if necessary, addressed) under Part XIB.

- A related line of argument in submissions was that an increase in access prices would be inconsistent with the outcomes expected from a competitive market (referring now to a hypothetically competitive market for the access service). This observation is not directly relevant to the ACCC's deliberations;[5] however, the observation is incorrect in any event. There is no necessary requirement for prices to fall in competitive markets, and plenty of competitive markets can be observed where prices increase (and, indeed, it is unusual for the average of all consumer prices not to increase). Rather, the outcome of competition that is well-established in the economics literature is that participants in competitive markets must expect to recover their costs (including a commercial return) if continued provision of a good or service is to result.[6]

Efficient investment and legitimate commercial interests

- Submissions argued that because little further investment is required in the "copper" fixed line network, incentives for investment should have little weight. Similarly, it was argued that Telstra only has the incentive to make the minimum necessary investments, and therefore investment incentives are of less concern when setting access prices.

- Regarding the need for investment, I am advised that even during the transition to the NBN, substantial capital expenditure has occurred in relation to the fixed line networks, and is forecast to continue over the next regulatory period, in order to maintain a continuity of service. I find this unsurprising – reliable telecommunications services are essential to modern commerce and have a substantial value to households, and the transition to the NBN is expected to take many years to complete. It follows that a continuing incentive for investment remains important. Moreover, under the ACCC's proposed "partially allocated cost" approach, Telstra would not even have the incentive to undertake the minimum level of investment as it would only expect to recover only a fraction of new costs incurred. In addition, substantial new investment is required in regulated telecommunications networks, and it could be expected that arbitrary decisions in relation to past

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5 The "outcome of competition" is not mentioned in the fixed principles, and the objects clause for Part XIC refers to "promoting competition" rather than to the "outcome of competition".

6 More specifically, long run equilibrium of a competitive market is obtained when an efficient new entrant expects to its recover costs (including a commercial return on investment), because under this condition there is no profit incentive for net entry or exit. It follows that it the cost of provision increases, so must the equilibrium price.

investments would colour expectations about how the ACCC may treat these new investments in the future.

- Submissions also argued that Telstra has already been fully compensated for the decline in demand caused by the NBN through the payments it will receive under its agreement with NBN Co. I understand that this was not the purpose of these payments – this is addressed in more detail in section 1.3.2 below.

- Submissions also argued that Telstra's legitimate business interests are protected because its prices for fixed line services are high in international terms and Telstra as an entity is profitable. Comparisons made between international prices for fixed line services and prices in Australia shed little light on whether the Australian prices are consistent with cost recovery, and references to Telstra's profitability confuses Telstra as a whole with the specific provision of its provision of fixed line services.

Other issues

Relationship between the cost allocation approach and the RAB

- Submissions argued that if the ACCC accepts Telstra's proposed cost allocation method, then consistency requires the opening RAB (i.e., the value prescribed in the fixed principles) also to be re-determined. It was argued that the ACCC set the RAB $900 million higher than otherwise in order to achieve an outcome for prices, which would not have been necessary if the Telstra's proposed cost allocation method was applied (this is referred to below as the "write-up").

- In my view, such an adjustment to the RAB is neither permitted by the fixed principles, and nor is it required to maintain consistency or fairness.

- First, the conditions under which the fixed principles may be varied or altered are clearly limited, and are not met in this case.[7] The fact that the fixed principles are difficult to set aside is intended – a key objective of the "building block" approach to regulation is to provide some certainty of cost recovery with respect to sunk assets. This would not be achieved if the fixed principles could be set aside easily.

- In addition, the proposition that it is inconsistent or unfair to leave the RAB value intact is also misplaced.

  – First, the value the ACCC determined for the opening RAB was only marginally above the depreciated historical cost accounting value, well below the depreciated current replacement cost and well below the value required to ensure a recovery of recent investments (given the deferred return of capital implied by TSLRIC price paths). Relative to other sectors, this

[7] The debate surrounds the choice of a cost allocation method, which therefore does not involve a "manifest and material error" or "information [that was] false or misleading". The remaining condition under which the fixed principles may be reopened is if there is an "unintended consequence" – however, it is a deliberate design feature of the "building block" approach that changes to the cost of the regulated service (including where this result from a change in the view about the appropriate allocation of costs) should result in a change to the regulated price rather than being "absorbed" through adjustments to the value assigned to past investments.

would be considered an unfair outcome even if that value could be recovered in full (which is what Telstra's proposed cost allocation approach seeks to achieve).[8]

 - Secondly, this argument assumes that the ACCC determined the opening RAB value as a mechanical function of the cost allocation method. This is not the case. The ACCC, appropriately, undertook a broad enquiry and weighed up a similarly broad range of factors when deciding on the opening RAB that it would apply.

- Even if the cost allocation method was considered integral to how Telstra's starting RAB was determined, it does not follow that a change to the cost allocation method will deliver Telstra a "windfall gain" as has been argued.
  - First, it follows from the discussion above that any gain to Telstra would be better characterised as a reduction to a "windfall loss".
  - Secondly, retaining the write-up to the RAB (but changing the cost allocation method) will not be the only error that can be said to be present in the starting RAB for the next period. Under the fixed principles, Telstra is only able to include in the RAB the capital expenditure that was forecast for the last regulatory period rather than what was actually spent – I understand that the detriment to Telstra under this principle is of a similar magnitude to the value of the write up to the starting RAB.

Relevance of precedents from the energy sector

- Submissions argued that precedents from the energy sector are irrelevant to the telecommunications sector in view of the difference of the objectives between the regimes.
- In my view, it is both desirable and appropriate to draw upon precedents from the energy sector when inquiring as to how the fixed principles are to be applied. In particular, the current regime is the result of the ACCC's decision to replace the previous regime (where access prices were based upon TSLRIC) with an energy-network-type regime (the "building block approach") to telecommunications fixed line services. It makes sense, therefore, when deciding what the fixed principles mean to inquire how the equivalent terms and concepts are used in the sector from which they were drawn. Moreover, there are many more similarities than differences in the issues faced by regulators, and their responses, across the two sectors.

1.3.2 Approach to declining demand

ACCC proposal for assets with declining demand

- The ACCC's position statement on the Telstra-NBN Co. arrangements has a number of elements, which include that:

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[8] The fact that Telstra ultimately accepted the opening RAB values that were determined in the 2011 final access determinations does not mean that those values were "fair". In my experience, it is not uncommon for regulated businesses to accept a starting point that is considered to be unfair in return for the greater certainty flowing from having that starting value "locked in" and thereby recoverable through future charges, together with the commitment under the building block approach that efficient new capital expenditure similarly will be recoverable.

  - Telstra's RAB will be adjusted to reflect the regulatory value of assets transferred to NBN Co. and NBN Co.'s use of the assets that NBN Co. is leasing will be factored into the cost allocation step when deriving the regulated fixed line access prices, and
  - Assets that remain with Telstra but whose use declines will have their regulatory values adjusted downwards to reflect that reduced use.

- While the first of these elements is appropriate, the second is not consistent with, nor possible under, the fixed principles.

- Removing some or all of the asset value associated with fixed line assets without compensation merely because demand has declined, as has been proposed by the ACCC, would mean that Telstra would not be afforded the opportunity to recover its costs. The ACCC's proposed approach is inconsistent with the fixed principles requirements relating to a prescribed approach to the RAB opening value and roll forward, and the requirement to provide an expectation for full cost recovery in accordance with the proper application of the building block approach.

- I observe that the fixed principles and Telstra's agreement with NBN Co. were developed at the same time in the full knowledge of each other. If the intention had been for Telstra to recover the cost of some of its assets through the NBN Co. agreement, then this is something the fixed principles could have provided for explicitly. It is clear, however, that they do not.

Other arguments about declining demand advanced in submissions

Declining demand and competitive markets

- Submissions argued that providing Telstra with an expectation of full cost recovery in the face of declining demand is inconsistent with outcomes in competitive markets. As I reasoned in my earlier report, I do not agree with this proposition.

- In competitive markets, investors must expect to recover their costs (including a commercial return) otherwise investment would not occur. When costs are expected to be recovered over an extended period, then an investor would either be expected to seek compensation for taking on demand risk (i.e., by setting a higher price), or shield itself from the risk of declining demand (i.e., by requiring a long term contract with fixed commitments).

  - Thus, full cost recovery in the face of declining demand is the same outcome that arises in a competitive market where investment is made under efficient long term contracts, and so is consistent with the outcome of a competitive market.

Compensation through increased mobile volumes or other payments

- Submissions also argued that Telstra will be a beneficiary of the demand reduction that is caused by a shift to mobile networks.

- However, I observe that any "compensation" that Telstra achieves through increased mobile penetration is incomplete and likely to be short lived because:

  - Telstra is only one of three mobile network carriers, and its benefit would be limited to its share of the increase in mobile use

- Telstra's increased return from its mobile business is limited to the amount in excess of the cost of serving that increased mobile demand, and

- To the extent that the switch to mobiles causes an increased utilisation of mobile assets and commensurate reduction in unit costs, competition between carriers would be expected to cause this to benefit to be passed through to customers (through lower prices or better service) over time.

- Submissions also argued that Telstra is shielded from the impact of declining demand through payments made by NBN Co. As I noted when addressing the ACCC's proposals, this is not what I understand to have been the purpose and scope of those payments.

Allocation of the consequences of declining demand

- Submissions also argued that Telstra's proposed cost allocation approach will permit it to pass on all of the consequences of a reduction in demand to access seekers.

- I also addressed this matter at length in my earlier report where I concluded that this was not correct. Rather, the more likely outcome is that:

  - to the extent that retail prices for fixed line services could increase (i.e., where permitted by competition from mobile services), then those prices would increase so that the consequence of the reduced demand is borne by final customers, and

  - where mobile networks constrain the pricing of retail fixed line services, Telstra would be expected to set access prices so that access seekers too could meet the competition from mobiles in order to maintain the use of the fixed line network.

1.4 Structure of this report

The remainder of this report is structured as follows:

- Chapter 2 responds to various comments made in submissions about Telstra's and the ACCC's proposed approaches to cost allocation for fixed line services,

- Chapter 3 addresses the issue of the approach to declining demand.

2. Cost allocation

The purpose of this chapter is to respond to various comments made in submissions about Telstra's and the ACCC's proposed approaches to cost allocation for fixed line services. In this chapter I respond to issues raised in submissions in the following order:

- The meaning of the fixed principles for cost allocation
- The consistency of the approach to cost allocation with the objects clause of Part XIC, and
- Other issues.

2.1 Meaning of the fixed principles for cost allocation

Summary of views in submissions

Submissions from iinet and Frontier Economics argued that the fixed principles provided the ACCC with sufficient flexibility to implement its preferred approach to cost allocation. Specifically, iinet considered that the ACCC's approach was consistent with the fixed principles as it allocates costs on the basis of each Declared Service's relative use, stating:[9]

> *However, on the current drafting of fixed principle 6.14(a), the ACCC's current approach is clearly consistent with fixed principle 6.14(a) because the ACCC's current approach does allocate costs as between the individual Declared Services on the basis of each Declared Service's relative use of the network as compared to each other relevant Declared Service.*

Frontier Economics argues that the drafting of the fixed principles provides the ACCC with discretion as to the "other services" that are to bear the share of costs, stating:[10]

> *In our view, the lack of clarity here about what is meant by 'various services' gives the ACCC some flexibility to determine the most appropriate approach, and whether it would need to consider changes in network usage across 'all' services.*

Response to submissions

It is my opinion that there is no ambiguity about how the cost allocation provisions of the fixed principles should be applied. In particular, this is because the provisions of the fixed principles are clearly drafted and are consistent with the orthodox approach to cost allocation for regulated entities.[11] To the extent that any ambiguity remains, when the cost allocation framework is considered in the context of the other requirements of the fixed principles, most notably the requirement to apply the

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9 iinet supplementary submission, p. 14.

10 Frontier Economics submission, p. 26.

11 I provided examples of the approach to cost allocation in other jurisdictions in my previous report. See: Incenta, 'Cost allocation for fixed line services', October 2014, pp. 35-42.

building block approach, it is clear that the ACCC's proposed approach to cost allocation does not comply with the requirements of the fixed principles.[12]

Turning to the arguments in submissions, iinet and Frontier Economics made different points. I therefore address each of their arguments separately.

In its submission iinet observes that the ACCC's partial allocation approach does indeed allocate cost according to relative demand and as such is consistent with the cost allocation Fixed Principle. However, as I demonstrated in my previous report on this matter, there are two ways in which the ACCC's partial allocation approach can be interpreted. Both of these interpretations are in violation of the fixed principles:

- First, the ACCC's approach can be interpreted as allocating costs based on relative use, but where the cost that is allocated is arbitrarily optimised. Under this interpretation the cost allocation Fixed Principle may be met – which is the point made by iinet – but not the other fixed principles. That is, the fixed principles do not authorise an arbitrary scaling down of the total cost pool in this manner. In particular, this is because this would not be consistent with the proper application of the building block model required under the fixed principles as it would not provide an opportunity for Telstra to recover its costs.

- Secondly, the approach may be interpreted as allocating the total pool of cost between services. Under this interpretation a much greater share of costs are allocated to the non-regulated services than the amount that reflects their relative use. Therefore, while the total cost pool may be calculated in accordance with the building block model, and therefore the fixed principles, the cost allocation Fixed Principle that refers to relative use is clearly not met.

The submission from Frontier Economics points out that the wording "various other services" gives the ACCC some discretion as to the "other services" (meaning unregulated services) that are to bear a share of the costs. Being able to exclude some services from an allocation of costs is not unconventional. It is common for unregulated services that are only trivial in scope to not be allocated a share of joint costs because of a concern, amongst other things, about administrative costs and the potential to inadvertently make other efficient uses of the shared infrastructure uncommercial.[13] However, this flexibility does not actually advance Frontier Economics' argument. If there are fewer unregulated services across which costs are to be allocated, then the share that remains to be recovered from the regulated services increases. The result being that regulated prices also increase.

2.2 Consistency with the objects clause of Part XIC

Submissions to the ACCC commented on the extent that alternative approaches to cost allocation are consistent with the objects clause of Part XIC of the *Competition and Consumer Act 2010 (Cth)* (objects clause). My consideration of the comments in submissions is separated into each of the key relative aspects of the objects clause that were raised by stakeholders, namely:

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12 I comment further on my understanding of the fixed principles in the context of the approach to cost allocation in my previous report on this matter. See: Incenta, 'Cost allocation for fixed line services', October 2014, pp.4-5.

13 I note for completeness, that it would be unconventional for some regulated services to be excluded from cost allocation where costs incurred contribute to the provision of the regulated service.

- The promotion of competition
- The encouragement of economically efficient investment and Telstra's legitimate commercial interests, and
- The encouragement of economically efficient use.

2.2.1 Promotion of competition

Summary of views in submissions

A number of submissions to the ACCC argued that Telstra's approach to cost allocation would either have a limited impact on the promotion of competition or would have a negative impact.

Submissions from Optus, iinet and Frontier Economics argued that Telstra faces significant cost advantages in the supply of retail services. The implication being that higher access prices would give Telstra a significant advantage compared to other providers.[14] For instance, iinet asserted that:[15]

> *Providing Telstra with protection, and a windfall through higher access prices, would give Telstra a significant advantage over and above its current dominant market position because Telstra would be in a position where it could set and keep its retail prices lower than access seekers' retail prices and aggressively win market share during the transition to the NBN.*

Frontier Economics stated:[16]

> *Further, when competing with access seekers in retail markets, Telstra faces its own marginal costs of supplying network services, not the rates set using the FLSM. This means that there will be little pro-competitive benefit from re-allocating costs using Telstra's method.*

In addition to comments focused on the impact on competitive rivalry, submissions from Optus and iinet also commented that Telstra's proposed approach to cost allocation would also not promote outcomes that are consistent with competitive market outcomes.[17] Most notably, these submissions expressed the view that competitive markets should result in lower prices rather than higher prices; noting that higher prices would be a consequence of Telstra's proposed approach to cost allocation.

Response to submissions

Will there be a promotion of competition?

I have not argued that Telstra's proposed approach to cost allocation – which in my view simply provides Telstra with the opportunity to recover its building block costs – will lead to a material increase in competition in the relevant markets. Rather, my view is that Telstra's approach to cost allocation is likely to be neutral to competition. To that extent, I agree with the position of Frontier Economics that there will be little pro-competitive benefit from Telstra's approach to cost allocation, although I would add that there will also be little detriment as well.

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14 Optus supplementary submission, p.9; iinet supplementary submission, p. 7; Frontier Economics submission, p.32.

15 iinet supplementary submission, p.7.

16 Frontier Economics submission, p.34.

17 Optus supplementary submission, p.5; iinet supplementary submission, p. 8.

As noted above, the effect of Telstra's proposal is that access prices should be set in line with the cost of providing the access service, so that the incentive and capacity for continued provision of the access service is thereby provided. It would be extraordinary if access prices determined in such a manner were incompatible with the creation of competition in related markets. Rather, the better view is that setting cost reflective access prices will be compatible with efficient or sustainable competition, in that such access prices will be both compatible with competition and with the continued efficient provision of the access service. Such an outcome would not be achieved if the building block approach was instead back-engineered to create a predetermined (non-cost reflective) price.

The more relevant issue for competition in related markets is not the level of access prices, but rather how Telstra's retail prices relate to the access prices and whether there is "room" for an efficient competitor. Such issues should not, and indeed cannot, be addressed through manipulating access prices, but rather can be investigated – and addressed if required – through Part XIB.

I observe that an assumption in the discussion above is that if Telstra is not able to recover its costs through access prices (i.e., the case under the "partially allocated cost" approach), then Telstra will bear that shortfall. The alternative that is advanced in submissions is that Telstra may still recover its costs by setting higher prices than otherwise in other markets (for example, its retail fixed line prices, mobile charges, etc.). To the extent that the ACCC's cost allocation approach does encourage this response, then there would be an effect on competition, that is:

- The ACCC's cost allocation approach (according to this argument) would encourage Telstra to raise its prices in other markets to maintain cost recover (which would not be necessary under Telstra's proposed cost allocation method)
- This price increase would have the effect of reducing the competitive constraint that Telstra's pricing applies in those other markets, and so
- It must then follow that the ACCC's cost allocation approach will reduce competition in the relevant markets relative to Telstra's proposed cost allocation approach.

Outcomes expected from competitive markets

First and foremost, the objects clause in Part XIC refers to the objective of promoting competition in markets for listed services – that is, its focus is on the creation and prospering of real-life competition where this is feasible. It is also clear from the context that what is intended is that the decisions of the ACCC be consistent with creating the conditions under which competition may develop and prosper – the requirement for the ACCC to have regard to the extent to which a "thing will remove obstacles" is consistent with this. The Part XIC objects clause does not state that an objective is for the ACCC to regulate in a way that generates the hypothetical outcome of a competitive market in markets where competition does not exist. As such, the line of argument from iinet and Optus about what the outcomes of competition may look like for the regulated fixed line services under a hypothetical assumption that competition exists is not relevant in the context of an assessment against the Part XIC objects clause.

Putting to one side the relevance of the outcomes of competition to the objects clause and turning to the merits of the arguments put by iinet and Optus, there is nothing in the economic literature that suggests that competitive markets would be expected to result in declining prices over time and therefore the outcomes asserted in these submissions. The fact that CPI inflation is typically above

zero (which is the average price increase for goods and services consumed by households, many of which are produced in competitive markets) suggest that this is not the case.

There are a number of outcomes that competitive markets may be hypothesised to deliver. Particularly relevant to this matter, however, is that a pre-condition for the continued provision of goods or services in a competitive market is that investors have an expectation that over the long run they will be able to recover all of their costs including a commercial return.[18] Indeed, standard economic theory suggests that over the long run if a firm was unable to recover its full costs the most likely outcome would be that investment would cease and the firm would ultimately withdraw from the relevant market, and that long run equilibrium would attain when a new entrant into the market would recover its costs including a commercial return. A corollary of this is that if unit costs increase then so should the market price, at least over the longer term.[19]

Moreover, while the impression that one may gain from submissions is that Telstra has proposed substantial price increases over the next regulatory period, it has in fact proposed prices that will decline in real (i.e., after CPI inflation) terms over that period. Given this outcome, it is difficult to understand the suggestion that competition may be affected in a material and detrimental way or that the outcome is materially different to what may be observed in competitive markets.

2.2.2 Efficient investment and legitimate commercial interests

In this section I address together the objective of encouraging economically efficient investment and the requirement to have regard to the legitimate commercial interests of the supplier. This is because submissions tended to treat them together but also because there is a natural relationship between them.

Summary of views in submissions

Optus indicated in its submission that access prices need to fall between marginal and stand-alone costs. It stated that the role of the ACCC is then to set prices that fall within this range subject to promoting the LTIE, balancing the need to promote competition and retaining the incentives to invest. Specifically, Optus stated:[20]

> *The impact is that there is no legislative requirement for access pricing to 'guarantee' that Telstra can recover all its costs. It is long accepted in telecommunications access pricing that the range of reasonable prices fall in a range between marginal cost and stand-alone costs.23 The role of the ACCC is to set prices which fall within this range and which best promote the LTIE – balancing the need to promote competition and retain incentives to invest. See Appendix A of Optus' submission to the Fixed Line FAD Discussion Paper for a discussion of this trade-off.*

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18 We note that over the short run a firm may be willing to remain in a market even where it has negative profits so long as revenue covers its variable costs. However, this is not a position that would be sustained over the long run.

19 In section 0 below I set out why an expectation of full cost recovery is consistent with outcomes that might be expected if the relevant services were provided in a competitive market and not subject to regulation.

20 Optus supplementary submission, p.8.

The appendix referred to by Optus in the quote above suggests that in an environment where no further investment in the copper network is warranted that the focus for the ACCC should be on the promotion of competition rather than incentives for investments.[21]

The submission from iinet argued that Telstra had no incentive to do anything other than make the minimum investments in the legacy network and, as a consequence, incentives for investment should hold no weight over the approach that is taken.[22] In addition, iinet argued that Telstra is already compensated from NBN Co. for the impacts of the NBN's introduction such that its legitimate business interests do not require access prices to rise. It claims, therefore, that Telstra's proposed approach to cost allocation leads to the double recovery of costs.[23]

Optus also indicated in its submission that relative to other international markets prices for fixed line services are high in Australia. It also argued that the evidence demonstrates that Telstra continues to be highly profitable. The implication drawn by Optus is that the evidence does not support the claim that Telstra will be disadvantaged by the ACCC's partial allocation approach to cost allocation.[24]

Response to submissions

I observe that Optus has acknowledged that ACCC needs to balance the promotion of competition with retaining investment incentives. As I indicated in my previous report, investment incentives are retained through the implementation of Telstra's proposed approach to cost allocation. This is because it provides for an expectation – but not a guarantee – of cost recovery. In contrast, the ACCC partial allocation approach discourages investment because Telstra would never expect to earn a normal return from that investment.[25]

The key argument made in submissions is that as little in the way of new investment is required in the "copper" fixed line network that the objective of encouraging investment should have little weight in the ACCC's decision making. In my view, this is incorrect for two reasons.

- First, Telstra has a substantial ongoing investment requirement in order to provide a continuity of service for fixed line services provided over the "copper" network in the period prior to the transition to the NBN.[26] I find this unsurprising – reliable telecommunications services are essential to modern commerce and have a substantial value to households, and the transition to the NBN is expected to take many years to complete. It follows that a continuing incentive for investment remains important.

- Secondly, even though the investment needs in relation to the "copper" network is diminishing, there will be a need for substantial investment in regulated telecommunications networks, as well as a need for substantial and ongoing investment in regulated networks in other sectors. It is reasonable to believe that arbitrary decisions in relation to past investments on the copper

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21 Opus submission, p.39.
22 iinet supplementary submission, p.7.
23 iinet supplementary submission, p.8.
24 Optus supplementary submission, pp.4-6.
25 This was shown in my first report: see: Incenta, 'Cost allocation for fixed line services', October 2014, p.12.
26 Telstra, 2014, Public inquiry into final access determinations for fixed line services—primary prices Response to Discussion Paper (confidential version), October, Figure 26 and Table 8 (pp.69-70).

networks would colour expectations about how the ACCC may treat new investments, including in other sectors, in the future.

I observe that an outcome whereby Telstra has the incentive to do no more than the minimum investment is desirable. However, it follows from the discussion above that the ACCC's partially allocated approach will not provide an incentive for Telstra to invest the minimum necessary – even on this amount, Telstra would only expect to recover only a fraction of new costs incurred.

Regarding iinet's claim that Telstra has already been compensated by NBN Co. such that its legitimate business interests are already assured, it is my understanding that the payment from NBN Co. is not compensation for assets but is for another purpose. Therefore, in this case these funds are not relevant to the cost allocation approach and cannot be rightly claimed as compensation in this respect. I address the matter of the arrangements between NBN Co. and Telstra again in section 0.

Turning to the case put forward by Optus regarding international prices and Telstra's profitability. These matters have no relevance to the approach for cost allocation. What matters is cost recovery. If higher prices are required to provide a reasonable assurance of cost recovery then the differential between Telstra's prices and international jurisdictions is appropriate. Further, the reference to Telstra's profitability confuses Telstra as a whole with its specific provision of fixed line access services. Any suggestion that a subsidy from other parts of the Telstra business can be used to maintain Telstra's legitimate business interests ignores the negative impacts that such a subsidy would have on competition and efficient use in those markets. I also address this matter further in the chapter below addressing declining demand.

2.3 Other issues

In this section I address two additional issues that were raised in the context of cost allocation, these issues are:

- The relationship between the cost allocation approach and the RAB, and
- The relevance of the use of precedents from the energy sector for telecommunications.

2.3.1 Relationship between the cost allocation approach and the RAB

Summary of submissions

Frontier Economics argued that the cost allocation model cannot be considered in isolation from the RAB and the previous methodology for setting prices. On this basis it commented that if the cost allocation approach is changed the RAB also needs to be reopened. Specifically, Frontier Economics argued that the ACCC "engineered" a RAB to give a set of prices consistent with prices at that time, and that if the ACCC had used the proposed cost allocation approach then a different RAB would have been determined. Further, it also asserted that it is inconsistent to argue that a different cost allocation approach should be used and to not allow the RAB to be reopened. In a subsequent submission Frontier presented its views in more detail and concluded that (i) the ACCC increased the RAB in 2011 to promote price stability, (ii) the increase in the RAB was only required because of the ACCC's use of the "partially allocated cost" approach, (iii) would not have been required if the

Telstra's proposed cost allocation approach had been used, and (iv) changing the cost allocation methods now will create a "windfall gain" to Telstra.[27]

Response to submissions

Can the ACCC reopen the RAB?

While Frontier Economics argued that the RAB should be reopened, it did not actually argue that the ACCC is able to do this under the fixed principles. It is my view that the ACCC cannot reopen the RAB. Clause 6.7 of the fixed principles is clear that the RAB is to be rolled forward in a formulaic way. I note also that a formulaic approach, such as is contained in the fixed principles, is consistent with other regulatory frameworks I have interacted with[28]. Further, clause 6.6 clearly states the opening asset value upon which the roll forward is to be based. It is my view, therefore, that there is no scope for interpretation about how the fixed principles are to apply.

With respect to the circumstances under which the fixed principles can be varied or altered, it is also clear that there is no question that these circumstances have not been met. The conditions for reopening the fixed principles require that there be a manifest and material error in the Fixed Principle provisions, information upon which the principles were based to be false or misleading or an unintended consequence.

- It is clear that there is no manifest error in the fixed principles. They represent a standard approach to setting a building block revenue requirement and no issues or unworkable elements in the principles have been identified.

- There is also no question of the ACCC having acted on incorrect information. It chose a method of cost allocation in 2011that was different to the method that Telstra proposed (Telstra having proposed a method that is very similar to its current proposal). It is this choice of method, not the information used to implement the method, to which Frontier Economics objects.

- The prospect that a change to the cost allocation method may cause prices to be different to what was forecast cannot be held to be an unintended consequence. Rather, the intended outcome under the building block approach is that any change to costs – including the proportion that is allocated to regulated services – should translate into a change in prices.

Importantly, it is also correct for the fixed principles to set a high hurdle for change, particularly in the context of the RAB. The standard view in regulatory economics, which is provided for in the fixed principles, is that economic efficiency is best promoted through certainty that the RAB will be rolled forward mechanistically and once assets are included in the RAB they will not be removed. This has been widely accepted by regulators as providing desirable confidence to investors that the costs of

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27 Frontier Economics (2014), Cost allocation methodology and its relationship to the opening regulatory asset value, December, pp.1-2.

28 I note, however, that there can be differences in the formula that is applied for rolling forward the asset base under such an approach. For instance in some circumstances, for the purposes of promoting efficient expenditure incentives, the regulator may review capital expenditure before it can be included in the RAB. However, this provision will be explicitly provided for and businesses know of this risk ex-ante and so can factor it into their decision making. Further, it is also perhaps more common that actual capital expenditure, rather than forecast amounts, are added to the RAB. Nevertheless, the principle of a mechanistic approach to the roll forward is consistent across regulatory frameworks.

long term investments can be recovered. Indeed, the ACCC itself was clear when it adopted the fixed principles that it intended the starting RAB value to be "locked in" – and therefore something that it envisaged ever being reopened – in order to provide certainty to participants:[29]

> *The December 2009 Discussion Paper suggested adopting a BBM approach to calculating prices for all the declared fixed line services. It noted that a BBM would improve certainty for the access provider and access seekers by 'locking in' the initial value of the regulated assets.*

In addition to this, making an adjustment to the RAB value when a mechanistic roll-forward model is specified to apply would have negative implications for perceptions regulatory risk. Moreover, given the similarity between the fixed principles and the regulatory instruments in other sectors, these impacts would be expected to extend to other sectors and beyond those regulated by the ACCC.

Would it be 'unfair' to maintain the current RAB?

I read the submissions from Frontier Economics as suggesting, primarily, that it would be unfair for the current RAB to be maintained where there is a change to the approach to cost allocation. To this end, Frontier concluded that a change to the cost allocation method now would deliver a "windfall gain" to Telstra.

It is my view that this position is questionable.

The value that the ACCC determined in 2011 for the RAB was only marginally above the ACCC's lower bound of depreciated historical (unindexed) costs and well below current replacement cost based valuations. Further, the value chosen was much lower than the value that Telstra argued would be required to allow a recovery of past investments in view of high recent levels of investment and the deferred return of capital (depreciation) implied by TSLRIC pricing. Relative to how regulatory asset values have been determined in other sectors, this would be considered an unfair outcome for Telstra, even on the assumption that the value could be recovered in full (which is the objective of Telstra's proposed cost allocation method).

I observe for completeness that the fact that Telstra ultimately did not challenge the opening RAB values that were determined in the 2011 final access determinations does not mean that those values were "fair". In my experience, it is not uncommon for regulated businesses to accept a starting point that is considered to be unfair in return for the greater certainty flowing from having that starting value "locked in" and thereby recoverable through future charges, together with the commitment under the building block approach that efficient new capital expenditure similarly will be recoverable.

Moreover, it is wrong to characterise the method that the ACCC used to set the opening asset valuation in 2011 as simply a mechanical function of the cost allocation method. It is clear that when deriving the RAB, the ACCC undertook a broad inquiry that weighed up a similarly broad range of factors. Indeed, this reflects the fact that economic principles provides less than definitive guidance as to the RAB that should be applied at the commencement of building block regulation. As such, the standard regulatory approach is to choose a value that is considered to be objectively fair for both the service provider and users. While the ACCC did discuss price stability as an objective that it considered important, this was not its only consideration.

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[29] ACCC, 2011, Public inquiry to make final access determinations for the declared fixed line services, Discussion paper, April, p.25.

However, if Frontier's interpretation of the ACCC's asset valuation method were correct, it does not follow that Telstra has made a "windfall gain".

First, as discussed already above, when compared to other industries, the starting RAB can be characterised as an unfair outcome. Accordingly, to the extent that the change to the cost allocation method will deliver Telstra a gain, this is something that would be better characterised as a reduction to a "windfall loss".

Secondly, the asset value "write up" identified by Frontier is not the only "error" that is likely to be contained in the starting RAB for the next regulatory period.[30] One of the peculiar features of the fixed principles is that Telstra's RAB is updated by including the *forecast* capital expenditure over the previous regulatory period, rather than the *actual* capital expenditure (the latter being a more typical approach), with the effect that if more is spent than forecast, then the overspend is not recovered. Telstra spent substantially more than forecast on capital expenditure during the last regulatory period, and I understand that the extent of unrecoverable capital expenditure (and therefore the downward error in the starting RAB for the next regulatory period) is of similar magnitude to the write up to which Frontier referred.

2.3.2 Relevance of precedents from the energy sector

Summary of submissions

In its supplementary submission Optus argued that there are differences between the telecommunications and energy sectors that need to be recognised when attempting to compare the approaches to cost allocation between the regimes. The implication drawn was that the features of Telstra, as well as the objective for the telecommunications framework, means it is not appropriate to draw on approaches in the energy sector for Telstra. Specifically, Optus states the following:[31]

> *Telstra and its advisors rely heavily on the regulatory approach in the utilities industries – mainly electricity and gas. There is an implicit assumption that these regimes are the same. While the fixed line services model is based on the same method employed in electricity and gas models, it is not correct to assume the regulatory regimes are the same – the use of the same modelling concept does not mean that Telstra is governed by the national electricity or gas rules. There are significant differences which neither Telstra nor its advisors recognise. These include:*
>
> *(a) Telstra is a multi-product firm in which regulated revenue represents a small part of over-all revenue. This can be compared to the role of price setting under the AER which set revenue caps for distribution and transmission network providers – a single product, single network monopoly.*
>
> *(b) The national electricity objective is to promote efficient investment in, and operation of, electricity infrastructure. This can be compared to the objective of Part XIC, which is to promote the long term interest of end-users through the promotion of competition.22 Telstra makes little, if any, reference to the impact on competition in related markets.*

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30 I have interpreted Frontier's argument as meaning that retaining this write up in the RAB would be an error if the cost allocation method were changed.

31 Optus supplementary submission, pp.7-8.

Response to submissions

First and foremost, my use of examples or precedents from the energy sector has been to shed light on the meaning of the fixed principles. To this end, I observe that the current telecommunications regime is the result of the ACCC's decision to replace the previous regime (where access prices were based upon TSLRIC) with an energy-network-type regime (the "building block approach" with a "locked in" starting RAB) to telecommunications fixed line services. For example, the ACCC noted in the preface to its December 2009 discussion paper that:[32]

> *In recent years, some industry participants have expressed a desire to move towards what they have described as a 'utility style' pricing approach to pricing telecommunications services.*

And further that:[33]

> *The ACCC has in particular noted its view that, when setting regulated access prices, regulatory certainty would be promoted if the value of the assets used to provide the regulated services was locked-in, rather than continually re-valued at each regulatory reset. It has also noted that the 'build or buy' rationale for continually re-valuing the asset base may not be as strong as initially envisaged.*

The "utility style" pricing approach referred to the approach adopted (amongst other things) in the energy sector, and the question of whether the RAB should be "locked in" or revalued over time was what the ACCC identified as the most material difference between the form of regulation that applied in the energy sector and the TSLRIC approach, with the former ultimately being adopted in the fixed principles. It makes sense, therefore, when deciding what the fixed principles mean to inquire how the equivalent terms and concepts are used in the sector from which they were drawn.

Beyond this, while all industries have their differences, there are also many similarities that give rise to similar regulatory challenges. In relation to the energy sector:

- There are regulated bottleneck facilities (networks), which are considered to have sufficient market power to subject to price regulation
- Those network businesses often also provide unregulated services, which is likely to increase in the future (with the introduction of contestability to metering services)
- Price regulation of the networks is applied in a manner that is intended to promote competition in related markets.

The most material difference between the sectors relates to the vertical integration in telecommunications fixed line services and the potential incentive and opportunity this provides to Telstra to affect competition in the related markets (albeit, with this incentive and opportunity moderated by the competition from mobile networks). However, as explained already above, it is Telstra's retail pricing relative to the access prices – and not its access prices – that are relevant to

32 ACCC, 2009, Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services: Discussion Paper, December, p.4.

33 ACCC, 2009, Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services: Discussion Paper, December, p.5.

competition in related markets. The telecommunications regime has specific provisions (in Part XIB) to investigate – and, if necessary, address – such concerns.

In terms of the overall objectives of the regimes, while I accept that each has different wording, the pursuit of economic efficiency is a central feature of each. I observe that Optus itself expressed a similar view in its first submission when considering the legislative criteria for making an access determination, stating:[34]

> *It is clear that the common elements across the main matters to be considered are the promotion of economically efficient outcomes — both usage and investment. One could argue that if a FAD promoted economically efficient outcomes then it promotes the LTIE and other matters. Much discussion has occurred on what is efficiency in the context of Part XIC.*

Indeed, Optus's proposed interpretation of the objects clause for Part XIC is very similar to the structure of the objectives for the energy sectors. Given this, there is no reason to suggest that choices made in telecommunications should be materially different due to different objectives between the energy and telecommunications sectors.

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[34] Optus submission, p.40.

3. Approach to declining demand

3.1 Introduction

The issue of how to address declining demand was a matter addressed in submissions to the ACCC as part of its review of access prices for fixed line services. It was also discussed by the ACCC in its Position Paper for the treatment of the Telstra and NBN Co. arrangements. In this chapter I address the matter of declining demand in each of these contexts.

In this chapter I provide my views on:

- The ACCC position with respect to assets exhibiting declining demand
- Comments made in submissions on the approach to declining demand, covering:
  - the expected outcomes of in competitive markets where demand reduces
  - the question of whether Telstra is shielded from the impact of declining demand in other ways, such as through payments from NBN Co. or via recovery of costs in other markets, and
  - where the consequences of declining demand are allocated under the different cost allocation approaches.

3.2 ACCC proposal for assets with declining demand

The ACCC's position

As noted in the Chapter 1, the ACCC proposes to deal with the assets that are subject to explicit treatment in the agreement between NBN Co. and Telstra in the following manner:

- The assets that are to be sold to NBN Co. will be removed from Telstra's RAB, with the value to be removed reflecting the regulatory value, and
- For the assets that are to be the subject of lease payments, NBN Co's use of those assets will be taken into account when applying the cost allocation principle from the fixed principles.

The first of these positions is consistent with established regulatory practice where regulated assets are subject to a transaction, and the second is consistent with a standard application of the cost allocation fixed principle. Accordingly, I agree with these proposals and do not address these matters further.

However, the ACCC in its Position Paper also proposes to remove a share of the regulatory values of assets utilised to a lesser extent from the asset base. Specifically, the ACCC states:[35]

[35] ACCC, 'Public Inquiry into final access determinations for fixed line services – primary price terms, Position statement on the treatment of the Telstra-NBN Co arrangements for regulated pricing', October 2014, pp.11-12.

> *In the ACCC's view, it is important to consider the impact that NBN migration will have on the assets that are used to supply declared services. The ACCC considers that a consequence of migration is that certain assets will be either decommissioned or utilised to a lesser extent. This will ultimately mean that some assets that are currently used to provide declared services will no longer be used for this purpose, either fully or in part.*
>
> *The ACCC considers that this should be accounted for in determining prices for the declared services. The ACCC's position on these assets is as follows:*
>
> - *assets decommissioned, and an appropriate share of assets utilised to a lesser extent, as a result of NBN migration should be removed from the regulated cost base, and*
> - *the amounts to be removed from the regulated cost base should be based on the regulatory value of those assets (that is, the values assigned to those assets in the FLSM) and not based on the value of payments received from NBN Co for the migration of customers.*

Response to the ACCC

Assessment against the fixed principles

The effect of removing some or all of the value associated with fixed line assets from the asset base without compensation would mean that Telstra would not be afforded the opportunity to recover its costs.[36]

For similar reasons to the conclusions I reached in relation to the ACCC's proposed "partially allocated cost approach",[37] the ACCC's proposed treatment of assets whose use declines as a consequence of the NBN is, in my view, inconsistent with the fixed principles. In particular, I note that:

- The fixed principle in relation to the roll forward of the RAB prescribes a starting value and a formula for adjusting that value over time. This clause does not contemplate or permit an adjustment to the RAB to take account of declining demand either generally or in the context of the transition to the NBN.
- The demand forecasts fixed principle does not permit some form of "deemed" demand forecast to be applied to generate an equivalent outcome to an explicit adjustment to the RAB, and
- The outcome of the ACCC's proposed adjustment is that the access prices will not be set at a level that provide a reasonable opportunity to recover costs, which is inconsistent with the application of the "Building Block" model as described in the fixed principles.

It would also be difficult to see how the criteria required for a reopening the fixed principles would be met (these were discussed in section 2.3.1). Again, there would appear to be no argument that there is a manifest error in the fixed principles or that they were based upon incorrect information. In addition, the proposition that Telstra be provided with an opportunity to recover its costs also cannot be held to

36 Compensation would be provided if Telstra was permitted to recover the write down through its access prices (for example, by recognising the additional amount as depreciation). From the context of the discussion, it would appear that this is not what the ACCC intends.

37 Incenta Economic Consulting, 2014, Cost allocation for fixed line services, October, section 3.2.

be an unintended consequence of a move to the building block model – in contrast, one intention of moving to the building block model is that greater certainty is provided that costs will be recovered.

Effect of the agreement between NBN Co. and Telstra

The ACCC has not argued that the agreement between NBN Co. and Telstra was intended to compensate Telstra for the loss to Telstra associated with the decline in use of the non-NBN assets during the transition to the NBN.

For completeness, however, I observe that it is difficult to see that the agreement could have had the effect of compensating Telstra in such a manner, and similarly difficult to see that such an outcome would have been desirable. In this regard, I note the following.

- First, in order for agreement between NBN Co. and Telstra to compensate Telstra for the writing down of these assets, then there would have needed to be a clear contemplation in the fixed principles that such a write down to Telstra's assets as their use declined would occur. It is relevant here that the agreement between NBN Co. and the fixed principles were developed at the same time and in full knowledge of each other.

- Secondly, given such a direction from the fixed principles, it would then have been expected that Telstra's evaluation of the agreement with NBN Co. would have recognised an additional loss as a consequence of the transition to the NBN. Given this, Telstra would have been expected to attempt to obtain commensurately higher compensation under the agreement.

- Thirdly, NBN Co. would then have been expected to pay a higher amount to Telstra under the agreement for customer migration than it otherwise would have (this is the corollary of the previous point).

As discussed above, there is no contemplation in the fixed principles that such a write down would occur. Rather the fixed principles – in setting out an equation for updating the RAB – are clear that such a write down would not occur. Accordingly, it would not have been expected that Telstra and NBN Co. would have intended the agreement to compensate Telstra for such a write down.

Turning now to whether such an outcome would have even been sensible, I note that the effect of NBN Co. compensating Telstra for this is that the write down to Telstra's assets would either be paid for by users of NBN services or the Commonwealth Government (and therefore tax payers). It is difficult to see that either of these outcomes would have been superior to recovering the cost of the assets in question from the users of those assets.

3.3 Reducing demand and competitive markets

Summary of views in submissions

Submissions from iinet and Optus sought to draw parallels between Telstra's circumstance for regulated fixed line services and outcomes in competitive markets. The assertion was that participants in competitive markets are not protected from declining demand in the same way that Telstra is proposing that it be protected.

More specifically, iinet argued in its submission that access seekers also make investments, and that these investments are not protected from falling demand in the same way as is suggested by Telstra. It argues that lost revenue from falling demand is just a fact of competition.[38]

Optus argued in its submission that legitimate business interests cannot be promoted by being able to set a price above what would be obtainable in a competitive market faced with declining demand, stating:[39]

> *2.23 Optus recognises that there remains an issue as to how to take into account loss in market share due to competition and migration to mobile services. But, as already observed in 2011, a firm operating in a competitive market cannot respond to declining market share by increasing prices as this reduces its ability to compete with alternative suppliers. It is clear that the legitimate business interest of access providers does not extend to allowing prices higher than that would be seen in a competitive market, since no business has a right to revenues higher than those obtainable in a competitive market.*

Response to submissions

As I stated in my previous report, in "text book" perfectly competitive or contestable markets, the issue of excess capacity never arises. This is because all investment is assumed to be fungible or reversible such that capacity can be increased or reduced if demand changes, and the unrecovered value of all past investments thereby recovered.

Putting aside the theoretical ideal, in a competitive market, to the extent that cost recovery was spread over an extended period, then the investor would either seek compensation if it is bearing demand risk (i.e., setting a higher price) or entering into a long term contract with fixed commitments to insulate itself from the risk to cost recovery. To this end, where there are few users of an asset, it is unlikely to be efficient for the asset owner to bear demand risk given that this is something over which the users are likely to have some control.

I note that the circumstance put forward by iinet, where access seekers also make investments, is different from the case for Telstra. Other access seekers are free to make a decision about the risks of declining demand for cost recovery and make investment and pricing decisions to this effect without being constrained by regulation. Notably, these businesses can take a view about whether it is likely that it will be adequately compensated through price for the risks associated with the investment, such as the risks associated with declining demand.

Telstra's proposal is that it be able to set prices that provide an expectation for cost recovery, notwithstanding the expected decline in demand. This is the same outcome that arises in a competitive market where investment is made under efficient long term contracts, and so is consistent with the outcome of a competitive market.

38 iinet supplementary submission, pp.19-20.
39 Optus supplementary submission, p.7.

3.4 Compensation through increased mobile volumes or other payments

Summary of views in submissions

Submissions from iinet and Frontier Economics both argued that a consequence of reduced fixed line use is increased mobile use. Each noted that Telstra would be a major beneficiary of a shift from fixed line to mobile services.

Optus, iinet and Frontier Economics also argued that the payments made by NBN Co. to Telstra mean that Telstra is already compensated for the revenue loss that is caused by reduced demand. For instance, iinet stated the following:

> *The Definitive Agreements between Telstra and NBN Co mean that Telstra will be compensated by NBN Co for services that are migrated to the NBN. Therefore, increasing the price of the Declared Services in order to reflect reduced demand caused by migration to the NBN will lead to Telstra being compensated twice. This issue has already been considered by the ACCC. In dealing with the issue of cost allocation for falling total demand during the 2011 FAD public inquiry, the ACCC came to the following conclusion (emphasis added, footnotes omitted):*
>
> *[ACCC quote omitted]*

Response to submissions

The first argument noted above is that, to the extent that the reduction in demand for Telstra's fixed line services is the result of a switch in consumption to mobile services, Telstra will receive a benefit from this through its mobile business. I observe that none of the submissions have sought to quantify the benefit that Telstra may expect through its mobile business. In my view, there are plausible arguments to suggest that this benefit would be incomplete (and most likely, much less than complete), and also short lived.

First, Telstra is only one of three mobile network carriers, and any benefit that it receives through a greater volume in mobile traffic or subscribers arising from the switch from fixed line networks would be limited to the proportion that it attracts.

Secondly, the benefit to Telstra from the proportion it attracts is limited to the surplus that it is able to achieve over and above the incremental cost of serving that additional mobile network use. Given the high rate of growth of mobile networks, it is understood this incremental cost can be material.

Thirdly, to the extent that a surplus is earned in the mobile business – meaning that an increase in asset utilisation and so reduction in unit costs is achieved – this would be expected to be short lived. Competition between the mobile network should result in this benefit being passed on to customers over time (either through reduced prices or higher levels of service), after which any implicit compensation that Telstra is able to achieve would cease.

With respect to the payments made by NBN Co., as I articulated previously, it is my understanding that these payments are not intended as compensation for a declining use of regulated assets. Further, none of the material presented in submissions gives me cause to take a different view. On this basis it

is incorrect to state that these payments are sufficient to preserve Telstra's legitimate business interests and that there is no need to provide for cost recovery for fixed line access services.

3.5 Allocation of the consequences of declining demand

Summary of views in submissions

Frontier Economics in its submissions argued that Telstra's proposed approach to cost allocation would impose demand risk onto access seekers. Specifically, it stated:[40]

> *An implication of the new cost allocation model is that it will impose demand risk on access seekers; that is, if total volumes on Telstra's network falls then the cost allocation factors to access services will rise (unless volumes for these services fall even faster than other services.)*

Response to submissions

I addressed the question of who is likely to bear the consequences of a decline in demand under both the ACCC's partially allocated cost approach and under Telstra's cost allocation approach in some detail in my previous report.[41]

In that report I concluded that the incidence of the consequence of the decline in demand is different between the ACCC's approach and Telstra's approach. I concluded that:

- the ACCC's approach results in all of the consequences of the decline in demand being borne by Telstra, and so shielding both access seekers and final customers from the increase in the unit costs that is caused when capacity is fixed but demand declines, whereas

- under Telstra's proposed approach, the outcome would depend upon the extent to which the retail prices for fixed line services are constrained by competition from mobile networks:

  - to the extent that retail prices were unconstrained, then Telstra's approach would lead to retail prices for fixed line services increasing, and final customers therefore bearing the consequences of the reduced demand, whereas

  - to the extent that retail prices for fixed line services were constrained by mobiles, then Telstra would be expected to set its own retail prices at a level that responded to that competition, and it would also be expected to set access prices to permitted access seekers to do the same in order to maximise the use of its fixed line infrastructure.

I therefore disagree with Frontier Economics view that Telstra's proposed cost allocation approach would result in access seekers bearing the consequences of the reduction in demand because this ignores:

- the likelihood that access seekers will pass on the increase in access prices to their final customers, and

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40 Frontier Economics submission, p.35.
41 Incenta, 'Cost allocation for fixed line services', October 2014, p.27.

- the incentive for Telstra to set access prices that allow access seekers to respond to competition from mobiles in order to maintain the utilisation of its fixed line networks.

I also observe for completeness that as Telstra is the largest “access seeker” on its fixed line network, it will inevitably bear the largest share of any consequence that is borne by access seekers.

4. Declaration

I have has made all of the inquiries that I believe to be desirable and appropriate in the preparation of this report and no matters of significance that I regard as relevant have, to my knowledge, been withheld.

Jeffrey John Balchin
21 December 2014