

Telstra Corporation Limited

The key principles underlying regulatory cost allocations

17 April 2014

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RegCostAllocationsPrinciplesKXL170414

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Inherent Limitations

This report has been prepared as outlined in the Purpose Section. The services provided in connection with this engagement comprise an advisory engagement, which is not subject to assurance or other standards issued by the Australian Auditing and Assurance Standards Board and, consequently no opinions or conclusions intended to convey assurance have been expressed.

KPMG have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

The findings in this report have been formed on the above basis.

Third Party Reliance

This report has been prepared at the request of King & Wood Mallesons in accordance with the terms of KPMG's letter of instruction dated 1 March 2014. This report is solely for the purpose set out in the Purpose Section and is not to be used for any other purpose. Neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way from reliance placed by a third party on this report for any other purpose. Any reliance placed is that party's sole responsibility.

1 Introduction

1.1 Purpose

This report has been prepared to assist Telstra Corporation Limited (Telstra) make submissions to the Australian Competition and Consumer Commission's final access determination for the Wholesale Asymmetric Digital Subscriber Line Service (WADSL) by also fulfilling the purposes set out in Section 4 of the letter of instruction from Malesons dated 1st March 2014 (letter of instruction), which is set out at Appendix A of this report.

1.2 The Expert

The author of the expert opinions set out in this report is:

Keith Lockey
KPMG
147 Collins Street
Melbourne VIC 3000

Keith Lockey's relevant training, qualifications and experience are set out in his CV attached at Appendix D.

1.3 The matters the Expert has addressed

Section 2 of the letter of instruction requires the Expert to address the following questions.

- a) What are the key principles that need to be considered in establishing any cost allocation framework for the purposes of setting prices under a building-blocks model? What is the basis for each of the key principles? Please give reasons to support your view as to why these are key principles.
- b) What are your views on the use of a fully allocated cost allocation approach in a regulatory setting?
- c) In setting out your opinions on (a) and (b) above, please provide your views on the following issues:
 - (i) consistency of cost allocators used in any cost allocation framework;
 - (ii) possible approaches to the allocation of shared costs to different services in the context of setting regulated access prices for a regulated business; and
 - (iii) the relationship (if any) between the assessment of efficient costs and the allocation of those costs.
- d) Any other matters that you consider may be relevant to the creation or use of a cost allocation model for the purposes of the Fixed Access Determination Inquiry.

The Expert's findings are set out at Section 2 of this report.

The nature and result of analyses and inquiries the Expert has made to inform these findings are set out at Section 3 of this report.

A glossary of terms used in the report, is set out at Appendix B.

The sources of information the Expert has referred to are set out at Appendix C.

2 Findings

2.1 The Expert's opinions

The Expert's opinions in response to each of the questions posed to the expert are set out below, together with summarised reasons for each opinion. Section 3 of this paper further addresses the questions asked of the Expert by developing and explaining in Section 3 an underlying logic from first principles.

However, these principles are neither novel nor unique. These are well established and have been applied consistently by Australian economic regulators since 1995, in a variety of regulatory cost allocation, ring fencing and reporting guidelines. The Expert authored one of the first of these guidelines¹ and has subsequently, authored and advised on subsequent guidelines and the application of the principles and methods they contain. This experience is set out in the Expert's curriculum vitae at Appendix D. The analyses set out in Section 3, which gave rise to the findings set out below also include cross-references to precedents provided both by economic regulators and the statutory accounting requirements of the Corporations Law and Australian Accounting Standards.

2.2 What are the key principles that need to be considered in establishing any cost allocation framework for the purposes of setting prices under a building blocks model?

The principles and their reasons are summarised below. The bases of each principle and the reasons are more fully explained in Section 3 of this report.

Section 3 also explains that these principles apply to both capital and non-capital costs.

2.2.1 Principle 1: Allocators should reflect a cause and effect relationship whenever practicable

This is necessary to provide a rational, transparent and replicable basis for selection for an allocation.

A cause and effect relationship also allows efficient costs to be allocated on a basis that maintains the nexus between the efficient cost and the factors that cause that efficient cost to arise.

In some instances, it may not be practicable to precisely identify and measure causal allocators of cost. In such cases, it may be necessary to substitute a close approximation to an ideal causal allocator, to provide allocations that do not differ materially from a causal allocation. Regulatory frameworks including the National Electricity Rules for example, recognise this. This matter is dealt with by Principle 4 below.

¹ Office of the Regulator-General, Victoria, 1997, Electricity Industry Guideline No 3, Regulatory Information Requirements, Issue No 1.

2.2.2 Principle 2: Allocations of cost between Services need to be on mutually consistent bases

This is an arithmetic requirement. If different allocators are used to allocate a single category of cost to different Services then it will not be possible to demonstrate that:

- a shared cost has been allocated completely and that the allocated costs in total do not exceed the shared cost; and
- the resulting allocations of cost represent allocations of efficient cost.

2.2.3 Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated

This basic arithmetic check complements Principle 2. It is necessary to demonstrate that:

- cost has been neither created nor lost as a result of the allocation; and
- the resulting allocations fairly reflect the causal relationship between each Service and the total shared cost.

2.2.4 Principle 4: Cost allocators need to be practical

This principle is referred to in the summary for Principle 1. A cost allocation that cannot be practically implemented and replicated is unlikely to be acceptable by a regulator as a basis to develop and assess costs under a building blocks approach. In practical terms, appropriate judgements may need to be made to assess and trade off the identification and measurement of precise cause and effect relationships, with potentially less precise surrogates that may be better capable of implementation e. Generally accepted principles of accounting materiality will apply to such assessments.

2.2.5 Principle 5: Allocators may change over time

Causal allocators seek to reflect underlying practical and operational cause and effect relationships between Services and shared costs. Because these relationships can be expected to change as technologies and operations change, including for reasons of improving efficiency, it is reasonable to expect that allocators may change correspondingly. Further as information systems change, it may become possible over time, to better identify or measure allocators that more closely describe causal relationships than had been the case in the past.

Because of these reasons, allocators should not be regarded as static or permanent, although except where a Service is undergoing frequent or significant change, they should also not be expected to change frequently.

2.2.6 Principle 6: Consistency and quality of allocation objectives and outcomes are more important than consistency of specific allocators

This is a corollary of Principle 5. If allocators were to be fixed permanently, they could result in inaccurate or inefficient allocations in the longer term.

2.2.7 Principle 7: Causal allocations of cost do not necessarily have continuous or directly proportional relationships with units of Service output

Not all cause and effect relationships are ones of direct proportionality. Also, the cause of a change in cost may be other than an incremental change in a unit of Service output. A cost may be necessary for a Service but is not triggered or caused by units of Service outputs.

2.2.8 Principle 8: The quantum of an allocator cannot be prescribed or fixed over multiple periods

This is because allocators should reflect underlying operational activity and realities. In the normal course of events for many costs, the proportion of a shared asset, resource or service, represented by a cost that is consumed by a Service, is unlikely to be static. Accordingly, the percentage of cost allocated to a Service is also unlikely to be static. Even if the regulated Service outputs themselves are static, the levels of activity of the other Services with whom the cost is shared may not be. In which case, the percentage of shared cost attributable to the regulated Service will change.

2.3 What are your views on the use of a fully allocated cost approach in a regulatory setting?

A fully allocated cost approach that uses *causal bases of allocation*:

- will result in a Service bearing cost that lies within the bounds of avoidable and standalone cost;
- will attribute to a Service costs that are reduced by the benefits of any efficiencies of scale that may result from a cost being shared between Services; and
- can allow individual prices to lie between avoidable and standalone cost, and be subject to a constraint that regulated Service prices in total do not recover more than total (fully allocated) cost.

3 Analyses and inquiries

3.1 What are the key principles that need to be considered in establishing any cost allocation framework for the purposes of setting prices under a building blocks model?

To answer this question, this section considers:

- why price setting under a building blocks model requires cost allocation; and
- the principles which on an *a priori* basis enable a cost allocation approach to meet these criteria.

For the purposes of this discussion:

- the quanta of costs are not considered since this examination of general principles is independent of the quantum of any specific cost;
- no distinction is made between capital and non-capital costs. In other words, the principles which are developed and explained below apply equally to both capital and operating expenditure. This is because a cost is distinguished as being capital or non-capital according to the duration of the economic benefits that the cost provides.² This distinction has no bearing on the question of whether the cost is incurred to deliver a particular Service; and
- the principles are of general application and are neither specific to, nor do they exclude cost categorisations or nomenclatures such as “overheads”.

Rather, the principles set out in this paper are of application to the attribution of expenditure in general, to different Services, regardless of the nature of the cost or Service.

3.1.1 Cost allocation – fundamental requirements

It is necessarily the case that an asset, resource or service and hence a cost, is incurred either:

- wholly; or
- in part

to deliver a Service.

Where a cost is incurred wholly and exclusively to deliver a Service, it must follow that it is not incurred to deliver any other Service. Therefore, it can be said to be 100% allocated or “directly attributed” or “directly attributable”³ to the Service.

² Australian Government, Australian Accounting Standards Board, 30 September 2012, Glossary of defined terms, “asset”.

³ For example, see: Australian Competition and Consumer Commission, May 2004, Draft Regulatory Reporting Guidelines for Gas Pipeline Service Providers, Glossary, p 31.

However, where a cost is not incurred exclusively to provide a single Service, then it is necessary to allocate the cost between the Service and other purposes of the expenditure. Thus, an allocation has the potential to attribute anywhere between 0% and 100% of a cost to a Service.

3.1.2 Cost allocation principles

Cost allocation principles should enable the acceptability of any potential method to be assessed on an *a priori* basis.

3.1.3 Principle 1: Allocations should reflect a cause and effect relationship wherever practicable

There is a potentially very great number of choices for a basis of allocation of a cost.

Some on the face of it, could be reasonable:

- for example, telecommunications costs could be allocated to different Services on the basis of the capacity they provide to different Services;

while others may not:

- for example, the telecommunications costs could be allocated to different Services on the basis of the proportion of users of those Services who have a certain hair colour.

Both approaches can provide arithmetically valid allocations of cost. However, that does not mean that the allocation itself is suitable or valid. Therefore, one needs a basis on which to select a valid rationale for allocation from a potentially unbounded population of all possible allocators. While one could argue that the second example given above is self evidently an unsuitable basis of allocation, it was chosen as an extreme example in order to illustrate a point. The need for a principle which can be used to select a valid rationale for allocation on an *a priori* basis is particularly important when alternative bases of allocation may be similar and/or are all arguably reasonable.

The objective of a cost allocation is to determine the cost of the proportion of the consumption of a shared asset, resource or service that a Service efficiently consumes.

The requirement for a cost as a whole (shared or otherwise), will inevitably be triggered by a need or event (a "cost driver").

The extent to which a cost driver is associated with a Service provides a rational or causal basis of allocation. In the absence of a causal link between a Service and a cost that is capable of being allocated to that Service, the cost and Service would be independent of one another and the cost could not then be fairly attributed to the Service. Where the relationship is quantifiable, the cost allocator is also quantifiable.

The concept of determining bases of allocation on a causal approach wherever practicable is well established in Australian regulatory practice. For example, it can be

found in both regulatory cost allocation guidance published in 1997⁴ and in the current National Electricity Rules.⁵

The use of causal allocation is also consistent with the concept that some costs may be wholly or directly attributable to a Service. Costs are necessarily subject to a cause, cost driver or trigger, it is just that where costs are directly attributable to a Service, the Service wholly accounts for the cost driver. Therefore, the distinction between:

- a wholly or directly attributable cost;
- an allocated cost; and
- a cost that is not allocated at all to a Service

is one of degree only. In each case, the Service accounts for:

- all;
- some; or
- none

of the causal driver, and hence allocator, of the cost respectively.

It follows that the identification of a supportable cost driver and hence causal allocation requires a knowledge of the activities that are undertaken to deliver a Service and how those activities trigger the needs for the consumption of assets, resource time and services, by the Service.

The use of a quantifiable and transparent causal cost driver can also help to assess the efficiency of an allocated cost. For example, if a shared cost is triggered by staff head count, then the efficiency of the amount of cost allocated to a Service can be assessed by reference to the efficiency of the staff head count associated with that Service.

3.1.4 Principle 2: Allocations of cost between Services need to be on mutually consistent bases

This is an arithmetic requirement. In the absence of this principle, excessive or incomplete allocations of shared cost could arise. This is illustrated by the following example.

Assume that:

- a category of efficient corporate cost that amounts to \$1.2m is to be allocated between two different Services A and B (e.g. the corporate function that the cost represents provides services to the two Services exclusively);

⁴ Office of the Regulator-General Victoria, 14 November 1997, Electricity Industry Guideline No 3, Issue No 2, paragraph 3.5.7 "Items that are not Directly Attributed are to be allocated on a Causation Basis". The Glossary of that document goes on to define Causation Basis as follows:

"Causal or Causation, Basis Relationship means in relation to a basis of allocation, that the allocator is a trigger of the consumption or utilisation of the resources or services respected by the costs or other account item, subject to the allocation."

⁵ National Electricity Rules v 61, Rule 6.15.2(3) and Rule 6A.19.2(3), Cost Allocation Principles.

- the cost is to be allocated to:
 - Service A on the basis of numbers of equivalent full time employees (FTEs); and
 - Service B on the basis of head count employee numbers; and
- Services A and B have the following employee numbers:

	Service		Total
	A	B	
FTE	80	20	100
Head count	80	40	120

Then on this basis:

- \$0.96m ($\frac{80}{100}$ FTE x \$1.2m) would be allocated to Service A; and
- \$0.40m ($\frac{40}{120}$ Headcount x \$1.2m) would be allocated to Service B

resulting in Services A and B together bearing \$1.396m, some \$0.196m more than the actual shared cost.

This would:

- “create” cost that does not fairly reflect the actual costs of assets, resources and services incurred;
- result in total costs allocated between Services A and B that are in excess of efficient cost; and
- be at variance with fundamental arithmetic and accounting principles that require the “sum of the parts to equal the whole” whenever a single amount is divided into portions.

3.1.5 Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated

This follows from Principle 2 described above. The costs allocated to different individual Services must be capable of being reconciled to the total costs that are being attributed to those Services.

The requirement for allocations of a cost to Services to reconcile to the total of the shared cost before allocation is a fundamental and longstanding regulatory requirement. Disclosure of this requirement is often mandated by regulators through “Disaggregation Statements” or documents of a similar kind. Examples can be found in sources as diverse as:

- Office of the Regulator-General, Victoria, 1997, Electricity Industry Guideline No 3, Issues 1 and 2;

- Australian Competition and Consumer Commission May 2004, Draft Regulatory reporting guidelines for gas pipeline service providers, Section 2.5, p 13 and Appendix 5; and
- Queensland Competition Authority, SEQ Price Monitoring Information Template for 2011-12.

Such a reconciliation requires all of the Services including non-regulated Services, to which a cost is allocated, to be considered. In the example in Section 3.1.4, whether either, both, or neither of Services A and B are regulated is irrelevant to the arithmetic and logical integrity of the cost allocations.

Consider the example in Section 3.1.4. It would not be possible to form a view on the allocation to Service A without knowledge of the total amounts of the allocator and shared cost, and hence the complementary allocation to Service B.

If Service B is not regulated a regulator has no role in forming a view on the cost of Service B. However, knowledge of how the remainder of the shared cost not allocated to Service A, has been allocated to Service B, will help prove the allocation to Service A. This is a purpose of the disaggregation statements described above.

3.1.6 Principle 4: Cost allocators need to be practical

Unless a basis of allocation can be measured and data to allow that measurement can be captured, it is unlikely to be of practical value.

The concept of materiality that is commonly employed by regulators⁶ and has a statutory definition through Accounting Standards⁷ is as important and relevant to cost allocation as it is to any other financial item.

For example, certain resource costs may be driven by the need for a resource to spend time on different Services. At a detailed level, it may be impractical to measure on a minute-by-minute basis how an employee's time is spent across the course of a year.

However, a minute-by-minute or hour-by-hour measurement and record is unlikely to be necessary or practical for regulatory purposes in the absence of any business need to record time in that way. For costs of this kind, broader brush or surrogate measurements based on data samples, diaries and normal or contracted work patterns can often provide sufficient precision of measurement to provide results that would not differ materially from a more precise measurement of an allocator.

⁶ For example see Office of the Tasmanian Economic Regulator, May 2013, Water and Sewerage Accounting Ring Fencing Guideline, Definitions, p 6. Other examples of the application of this concept in regulatory guidelines and requirements stretch back to 1997 and include the Cost Allocation Principles of the National Electricity Rules.

⁷ Australian Government, Australian Accounting Standards Board, September 2012, Glossary of Defined Terms.

It is for these reasons that regulators often permit non-causal basis of allocation, but usually on the bases that:

- a non-causal basis provides a good proxy for a causal basis of allocation; and
- non-causal bases of allocation are not applied to material amounts.

Again, the Cost Allocation Principles in the National Electricity Rules exemplify this.

3.1.7 Principle 5: Allocators may change over time

The principles set out above have established that allocators should reflect underlying causal relationships between a Service and its efficient needs for assets, resources and services, shared with other services.

In the normal course of events or especially as businesses develop changed and more efficient ways of delivering Services, these requirements and the technologies and methods applied to deliver Services can be reasonably expected to change. Such changes may also properly cause changes in the causal relationships on which allocators are based and hence the allocators themselves. Furthermore, as accounting and data capture systems develop, it may often be possible to more accurately or practically identify and measure allocators, which may also lead to allocators changing over time.

3.1.8 Principle 6: Consistency and quality of allocation objectives and outcomes are more important than consistency of specific allocators

The consistent application of accounting policies is a generally accepted accounting principle⁸. This is to allow fair comparisons over time. The principles explained above provide a policy of allocation based on causal relationships. Where the nature of a causal relationship may change or the means of measuring and qualifying the relationship may be refined, the allocators may need to change. Such a change would be consistent with the Australian Government's statutory accounting policy requirements.⁹ Accordingly, unless regulatory requirements:

- permit allocators to change; and
- do not prescribe allocators

there are the risks of cost allocations:

- delivering distorted outcomes; and
- precluding the development of allocators that can provide more relevant and reliable allocations of efficient cost in the longer term.

⁸ For example, see Australian Government, Australian Accounting Standards Board, Standard AASB 108 "Accounting Policies, Changes in Accounting Estimates and Errors, p 15.

⁹ Ibid.

3.1.9 Principle 7: Causal allocations of cost do not necessarily have continuous or directly proportional relationships with units of service output

The existence of a causal relationship does not necessarily imply that a shared cost varies continuously or directly with the units of output of a Service.

For example, some costs may be necessary to provide the setting for, or the first unit of output of, a Service. The causal relationship may be one where the cost may not vary with the scale of Service outputs, or it may vary in discontinuous steps. Such costs can be referred to as 'fixed' costs and 'stepped' costs respectively. However, the term 'fixed' costs can be a misnomer. This is because all costs vary or are triggered by one cause or another. 'Fixed' costs simply vary according to causes other than incremental changes in output.

The costs of assets, resources and services that provide Service capacity are examples. They may not change with output but may increase in steps or when additional capacity is required.

Other examples would include many kinds of corporate costs. For example, Services that are delivered by limited companies are obliged to incur corporate compliance costs such as company secretarial costs, which are not triggered or caused by units of output. However, the company secretarial costs of a major listed corporation are normally on a different scale to a small privately owned corporation.

Costs of this nature form part of the standalone costs of Service provision. The question of how these costs are allocated between Services when a shared cost could potentially be wholly attributable to each Service, is considered at Section 3.2.

3.1.10 Principle 8: The quantum of an allocator cannot be prescribed or fixed over multiple periods

An allocation made in accordance with the principles described above will reflect the use or consumption of an asset, resource or service by a Service, relative to other Services that may also give rise to a requirement for a shared cost.

It is not reasonable to expect that levels of Service provision will necessarily be identical from period to period. Where there is any change in the relative consumption of an asset, resource or service between Services, the proportion of shared cost allocated to a Service should change too.

Some drivers of shared cost may be less likely to change frequently or at all. For example refer to Principle 7 described in Section 3.1.9 above. However, this does not change the principle that it is unreasonable to expect that the relative consumption of a shared cost by different Services and the associated percentage allocation of cost, will necessarily be constant or fixed. If it were assumed to be fixed, in many cases this would result in allocations of shared cost that would not be fairly stated because relative changes in consumption would not be accounted for.

3.2 The use of a fully allocated cost approach in a regulatory setting

The use of a fully allocated approach that uses causal bases of allocation avoids and does not necessitate the allocation of any inefficient or redundant cost that is not fairly attributable to a Service.

Firstly, the assessment of efficiency of a shared cost in total prior to its allocation, is independent of the allocation method. Secondly, a causal basis of allocation should only allocate to a Service costs caused by that Service.

Under a price cap where the maximum average price of a Service is regulated, regulated Service providers may be able to recover more or less than shorter term efficient cost, because the regulatory price control mechanism explicitly allocates Service volume risk to the Service provider. The building blocks may also include performance incentive payments or penalties, or efficiency carryforwards or penalties, that intend to reward or penalise a Service provider for past efficiencies or inefficiencies.

However, in the absence of such explicit mechanisms that provide for an under or over-recovery of efficient costs over the course of a regulatory control period, the building blocks approach seeks to recover efficient cost. The principles in Section 3.1 provide the rationale for such attributions under a fully allocated cost approach.

The recovery of cost is effected by tariffs or charges. Regulatory frameworks usually require individual tariffs or charges to be set on an economically efficient basis, whereby an individual tariff or charge may lie between avoidable cost and standalone cost.¹⁰

Where there are shared costs, it is possible for costs allocated to a Service using a fully distributed approach, to be *less* than standalone cost because the Service is able to benefit from economies of scale associated with sharing costs. For a standalone cost to be less than an efficient shared cost allocated to a Service on a causal basis, there would need to be diseconomies of scale.

A Service provider or a regulator could determine to set individual prices on a standalone basis. Provided this is an agreed regulatory policy, this can be accommodated by the cost allocation principles outlined above. The standalone costs allocated to a particular tariff or price may include any shared costs fully allocated to the Service that as explained above, have the potential to include efficiencies arising from the cost being shared with other Services.

A fully allocated cost approach also provides a total revenue constraint of total efficient cost of a Service.

¹⁰ For example, see National Electricity Rules v 61, Rule 6.7.1(1) and (2), Negotiated distribution services. The 'floor' and 'ceiling' prices of rail access regimes provide further examples.

A particular issue can arise where a shared cost may also be a “fixed” cost that is required by each of several Services. Consider an example where such a cost is shared between two Services A and B.



The shared cost could potentially be allocated in its entirety to either Service A or B, on a standalone basis.

In such an instance, the shared cost is likely to be allocated in equal proportions between Services on the basis that each have equal needs and requirements for the services provided by the shared cost and there may be no causal reason to attribute more to one Service than the other. In this way, both A and B would benefit equally from the efficiencies arising from them sharing in the same ‘fixed’ cost.

4 Expert's statement

In preparing this report I have made enquiries, described in this report, which I believe are desirable and appropriate to addressing my instructions set out in paragraph 2 of Appendix A. To my knowledge no matters have been withheld which arose from my enquiries and I regard as significant to my findings.



Keith Lockey

A Letter of instruction from King & Wood Mallesons

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1 March 2014

Mr Keith Lockey
Executive Director
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By email: klockey@kpmg.com.au

Dear Mr Lockey

Preparation of independent expert report in relation to the key principles underpinning regulatory cost allocation models

1 Introduction

1.1 We act for Telstra Corporation Limited ("Telstra") in relation to the Australian Competition and Consumer Commission's ("ACCC") current Fixed Line Services Final Access Determinations Inquiry ("FAD Inquiry").

1.2 Telstra has requested that we engage you to prepare an independent expert report addressing the questions set out in section 3 of this letter, for the purpose of assisting us in providing legal advice to Telstra. Those questions relate to the economic principles and general framework that apply to the adoption and implementation of any regulatory cost allocation model.

2 Background

Regulatory framework

2.1 The *Competition and Consumer Act 2010* ("CCA") sets out a regime for the provision of access to "declared" telecommunications services. The object of this regime is to promote the long term interests of end-users ("LTIE").

2.2 The CCA enables the ACCC to declare an "eligible service", being:

- (a) a listed carriage service (within the meaning of the *Telecommunications Act 1997*); or
- (b) a service which facilitates the supply of a listed carriage service (within the meaning of the *Telecommunications Act 1997*),

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Mr Keith Lockey

1 March 2014

where the service is supplied, or is capable of being supplied, by a carrier or a carriage service provider (whether to itself or to other persons).

- 2.3 If a service is declared (based on the ACCC's assessment of the declaration criteria set out in the CCA), the access provider must comply with certain Standard Access Obligations if it self-supplies the declared service or supplies it to another access seeker.
- 2.4 An access provider may provide access to a declared service (and comply with certain other Standard Access Obligations) either by supplying the declared service pursuant to an agreement with an access seeker or pursuant to the terms set out in a Final Access Determination ("FAD") issued by the ACCC under the CCA.
- 2.5 FADs which specify terms and conditions of access to the declared service(s) must include terms and conditions relating to price or a method of ascertaining prices for access to the service(s).
- 2.6 On 20 July 2011, the ACCC issued FADs ("2011 FADs") in respect of the following declared fixed line services:
 - (a) the unconditioned local loop service ("ULLS");
 - (b) the wholesale line rental ("WLR") service;
 - (c) the line sharing service ("LSS");
 - (d) the public switched network originating access ("PSTN OA") service;
 - (e) the public switched network terminating access ("PSTN TA") service; and
 - (f) the local carriage service (LCS), further
 - (g) the wholesale digital subscriber line (WDSL) service was subsequently declared by the ACCC with a FAD issued in 2013,(together, the "Fixed Line Services"). The FADs included price terms and conditions determined by the ACCC. Copies of the 2011 FADs are attached to this letter.
- 2.7 Unless extended, the current FADs for the fixed line services will expire on 31 July 2014.
- 2.8 On 11 July 2013, the ACCC commenced a public inquiry into making further FADs for the Fixed Line Services, which will determine the terms and conditions, including price, for access to the Fixed Line Services and the Wholesale ADSL ("WADSL") service after the expiry of the existing FAD.

3 Instructions

- 3.1 Telstra anticipates that the cost allocation methodologies adopted by the ACCC will be a critical issue in the current FAD Inquiry. Accordingly, to assist us in providing legal advice to Telstra, we are instructed to request that you prepare a report providing your expert opinion in relation to the following matters:
 - (a) What are the key principles that need to be considered in establishing any cost allocation framework for the purposes of setting prices under a building-blocks model? What is the basis for each of the key principles? Please give reasons to support your view as to why these are key principles.

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Mr Keith Lockey

1 March 2014

- (b) What are your views on the use of a fully allocated cost allocation approach in a regulatory setting?
- (c) In setting out your opinions on (a) and (b) above, please provide your views on the following issues:
 - (i) consistency of cost allocators used in any cost allocation framework;
 - (ii) possible approaches to the allocation of shared costs to different services in the context of setting regulated access prices for a regulated business; and
 - (iii) the relationship (if any) between the assessment of efficient costs and the allocation of those costs.
- (d) Any other matters that you consider may be relevant to the creation or use of a cost allocation model for the purposes of the FAD Inquiry.

4 Assumptions

- 4.1 In providing your report, please use the information provided by Telstra as set out in this letter, the ACCC documents referred to in this letter, and in the enclosed documents.
- 4.2 If, in providing your opinion, you have made any other assumptions, including factual assumptions, please set out the basis for those assumptions.

5 Documents

- 5.1 We enclose copies of the following documents to assist you in preparing your report:
 - (a) a copy of the *Public inquiry to make final access determinations for the declared fixed line services – Discussion paper*, dated April 2011;
 - (b) a copy of the 2011 FADs;
 - (c) the *Guidelines for Expert Witnesses in Proceedings in the Federal Court of Australia* (“**Guidelines**”).

6 Expert witness guidelines

- 6.1 The primary purpose of your report is to provide an expert opinion to assist us in providing legal advice to Telstra. However, it may also be provided to the ACCC as part of further consultation into these issues. Depending on the circumstances, Telstra may also require your report to be adduced as evidence in review proceedings before the Federal Court of Australia. Accordingly, your report (or certain aspects of it) may be accessible to the public.
- 6.2 The Federal Court also requires any person providing an expert report, or giving expert evidence, to comply with its Guidelines.
- 6.3 Please review the Guidelines to ensure that your report conforms to them and in particular we request that you maintain separate records of:
 - (a) all instructions;

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- (b) the facts, matters or assumptions upon which your report proceeds;
 - (c) the documents and materials you have been instructed to consider; and
 - (d) the documents and materials upon which you rely in support of your reasoning in the report.
- 6.4 The Guidelines do not address exhaustively all aspects of an expert's duties when providing a report or giving evidence in Federal Court proceedings. If you have any questions about the Guidelines, or queries about other matters relating to your duties, please bring these to our attention.
- 7 Other matters**
- Confidentiality**
- 7.1 These instructions and any information or documents that Telstra provides to you in relation to these instructions are confidential. To maintain confidentiality, we request that you:
- (a) use Telstra's confidential information only for the purposes of preparing your report;
 - (b) not disclose Telstra's confidential information to anyone without Telstra's written consent;
 - (c) if requested by Telstra, destroy or return to Telstra all records containing Telstra's confidential information; and
 - (d) address all of your communications to King & Wood Malleasons.
- Your fees**
- 7.2 Telstra has requested that you provide a fee estimate for your work as soon as practicable.
- 7.3 Once this estimate is approved, please send your invoices for preparing the report directly to us.
- Correspondence**
- 7.4 Please direct all correspondence in this matter to King & Wood Malleasons, for the attention of Sarah Weinberg and Wayne Leach.
- Presentation of your report**
- 7.5 Please include the following with your report:
- (a) a copy of your curriculum vitae including qualifications, experience in the field and any publications;
 - (b) our instructions to you;
 - (c) any other facts, matters, documents or assumptions upon which you rely in preparing your report;
 - (d) any plans, calculations, analyses, measurements or other material that you refer to in your report; and

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- (e) any enquiries you make that are necessary to respond to the questions we ask you to consider and also the results of any such inquiries.

Please contact us if you require any further instructions or material to prepare your expert report.

Thank you for agreeing to assist Telstra in this matter.

Yours sincerely

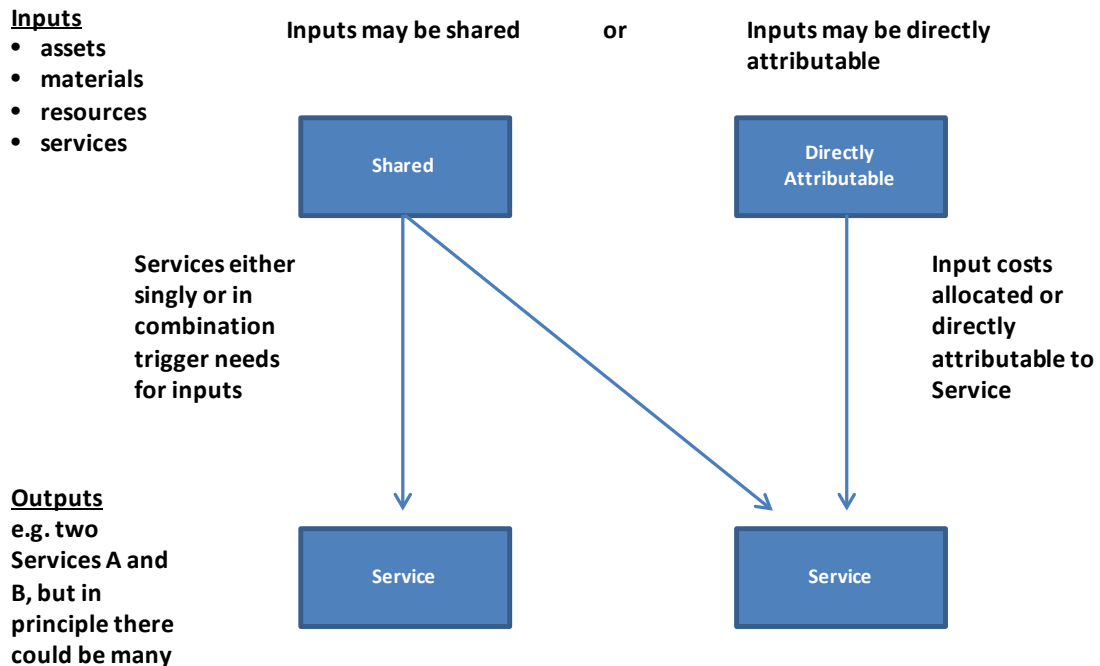
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B Glossary of terms

avoidable cost	total cost which is avoided if the Service output is not produced
regulatory control period	the period that is covered by a multi-year building blocks model, prior to the next regulatory determination
Service	the Service whose outputs are being costed by a building blocks model (see diagram below)
service	an input service required to provide the Service (see diagram below)
standalone cost	the total cost required to provide a Service if the Service was provided on a standalone basis in isolation from any other Service.

The relationships between the key factors described in this paper are illustrated below.



C **References**

Australian Competition and Consumer Commission, 27 June 2012, Final Access Determinations:

- No 1 of 2011 (LSS)
- No 2 of 2011 (LLS)
- No 3 of 2011 (PSTW OA)_
- No 4 of 2011 (PSTN TA)
- No 5 of 2011 (ULLS)
- No 6 of 2011 (WLR)

Australian Competition and Consumer Commission, April 2011, Public inquiry to make final access determinations for the dedicated fixed line services – Discussion Paper

Australian Competition and Consumer Commission, May 2004, Draft Regulatory Reporting Guidelines for Gas Pipeline Service Providers

Australian Government, Australian Accounting Standards Board, 30 September 2012, Glossary of defined terms

Australian Government, Australian Accounting Standards Board, Standard AASB 108, Accounting Policies, Changes in Accounting Estimates and Errors

National Electricity Rules v 61, Rule 6.15.2(3) and Rule 6A.19.2(3)

National Electricity Rules v 61, Rule 6.3

National Electricity Rules v 61, Rule 6.7.1(1) and (2), Negotiated distribution services

National Gas Rules v 19, Rule 76

Office of the Regulator-General, Victoria, 1997, Electricity Industry Guideline No 3, Regulatory Information Requirements, Issue No 1

Office of the Tasmanian Economic Regulator, May 2013, Water and Sewerage Accounting Ring Fencing Guideline

D Curriculum vitae

Keith Lockey

Director



Keith Lockey

Director

KPMG
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Certifications & Professional Memberships

- BSc (Hons) (Environmental Sciences), University of Lancaster
- Institute of Chartered Accountants in England and Wales

Profile/Overview

Keith co-leads KPMG's infrastructure, pricing and economic regulation team. He specialises in advising governments, utilities and other economically regulated industries on matters of industry reform, economic regulation and pricing and funding arrangements. Keith has expertise in undertaking financial analyses and costing to inform the determination of regulated prices and revenues. He has worked almost exclusively in this area since 1995.

Experience – examples

Major Australian telecommunications service provider: Regulatory imputation test – Keith carried out a regulatory imputation test to assess whether charges for third party mobile network access were sufficient to facilitate retail competition. This involved examining cost reports prepared in accordance with regulatory accounting separation requirements, to determine and report on, the relevant costs of service.

Australian Energy Regulator – Review of Cost Allocation Methods (CAMs). Keith assisted the AER to review the CAMs of a number of businesses for compliance with the requirements of the National Electricity Rules and the AER's guidance, and to advise the AER on possible future directions for its accounting separation requirements in the electricity sector.

Office of the Tasmanian Economic Regulator. Keith advised the regulator on the development of a regulatory accounting guideline and reporting templates for the water industry.

National Heavy Vehicle Regulator Project Office – Cost Consultancy. Keith led a team that collected and analysed the forecast costs and supporting assumptions provided by jurisdictions throughout Australia, of implementing arrangements for the national regulation of heavy vehicles.

National Rail Safety Regulator Project Office – Cost and capability study. Keith led a team that assessed the costs and capabilities of jurisdictional rail safety regulators, prior to the formation of a national regulator.

Queensland Competition Authority – Water business price monitoring. Keith led a team that developed templates to collect financial information to assist the QCA with monitoring price and a financial model for analysing that information in accordance with building block principles.

Office of the Tasmanian Energy Regulator: Redesign and simplification of regulatory accounting requirements - Regulatory developments and modifications to the templates led to the need to review Tasmania's regulatory accounting requirements for the electricity distribution industry.

Allgas: Assistance with compliance with regulatory accounting requirements - Keith helped this gas network operator to develop reporting procedures to help demonstrate compliance with regulatory accounting requirements.

Electricity Transmission Network Owners Forum (ETNOF): Transmission cost allocation guidelines 2007 - Keith carried out an engagement for ETNOF (which represents all the principal Australian Electricity Transmission Businesses) to review draft Cost Allocation Guidelines published by the Australian Energy Regulator.

Transend Networks Ltd: AER Cost Allocation Methodology Manual (2007 and 2008) - Keith led a KPMG team that drafted a "Cost Allocation Methodology" required by the Australian Energy Regulator, to demonstrate the allocation of costs between different transmission services in accordance with the National Electricity Rules. KPMG also

drafted an accompanying cost allocation and regulatory reporting procedures and process manual to assist Transend.

Transend Networks Ltd: Allocation of shared costs to unregulated business activities – Keith advised on the consistency of an allocation approach developed by Transend with good business practice and regulatory requirements.

Queensland electricity network businesses: Electricity industry regulatory accounting guidelines - Keith was engaged by industry to assess the Queensland Competition Authority's Guidelines published as part of the 2005 Price Determination.

Australian Competition and Consumer Commission: Record Keeping Rules - Keith reviewed draft accounting separation and cost allocation rules (regulatory accounting requirements) for the postal industry drafted by the ACCC and provided a range of suggestions and advice to improve their workability.

Australian Competition and Consumer Commission: Accounting Ring Fencing Guidelines for Gas Transmission Businesses - The Commission engaged Keith to review a jurisdictional regulator's guideline as a basis for accounting ring fencing for gas transmission pipeline service providers, under the Gas Code. Keith was then engaged to draft a guideline. This was designed to allow service providers to meet the Commission's objective of demonstrating compliance with the National Gas Code, while following generally accepted accounting principles and seeking to minimise the regulatory burden for both service providers and the Commission.

Major New Zealand gas distribution and transmission business: Advice on regulatory accounting requirements - Keith assisted a major gas network business to comply with the New Zealand Commerce Commission's Avoided Cost Accounting Method ("ACAM") for regulatory financial reporting.

Department of Infrastructure, Victoria: Development of accounting information reporting requirements for public transport franchisees - Keith was engaged by the Victorian government throughout 2002 and 2003 to identify financial and performance reporting requirements for monitoring and assessing the profit levels of Victoria's public transport franchisees. The outputs of this work included developing and consulting with franchisees on an information requirements guideline.

Transgrid – Negotiated Services Pricing – Keith led a team that developed a model that enabled prices to be calculated on the basis of both standalone and incremental allocations of cost, in accordance with the National Electricity Rules.

Northern Territory Power and Water Corporation: Development of an industry based cost ring fencing guideline - Keith developed a "self-regulating" cost ring fencing guideline.

Office of the Tasmanian Electricity Regulator: Electricity Industry Regulatory Accounting Guidelines - In consultation with regulatees and with regard to the ACCC's proposals for transmission pricing, Keith developed the regulator's original regulatory accounting guidelines for distribution and transmission businesses.

Electricity network businesses throughout Australia: Review of regulatory accounting submission - Keith has been engaged by different electricity networks to review regulatory accounts for compliance with regulatory requirements, prior to submission.

Australian Competition and Consumer Commission: Review of Electricity Transmission Business Co Regulatory Information Guidelines - Keith reviewed and provided constructive advice to the ACCC on proposed regulatory information guidelines to help it achieve its objectives in a practical, workable way aiming to minimise the information burden on business. Subsequently a small team led by Keith drafted revised Guidelines.

Office of Regulator-General, Victoria ("ORG"): Regulatory management secondment -

Shortly after its establishment, Keith was seconded to the ORG for 15 months to: manage and implement the process of acquiring and analyzing regulatory accounts from electricity distribution businesses. This included drafting Issues 1 and 2 of the regulator's cost allocation and regulatory accounting guideline.

Australian Competition and Consumer Commission - Keith organised and participated as a key speaker at a one-day workshop held with the ACCC on regulatory accounting, that explored both issues of principle and practice.

Legal advisors to MurrayLink - benchmarking of efficient forecast business costs - Keith has provided independent expert advice on issues of cost efficiency and allocation key to cost recovery.

CitiPower and Powercor – Independent expert reports on the efficiency of shared costs. Keith authored reports that assessed whether the costs of shared network operating services attributed to each network were prudent and efficient.

Assessment of potential for cross-subsidies in a vertically integrated energy utility - Keith undertook a study that reviewed the potential for economic cross- subsidies both within the utility and with other parties to assist with planning disaggregation options.

Power and Water Authority: Assessment of cost allocations and the bases of CSO payments for electricity supply - Keith advised on appropriate responses to government guidelines on and a regulator's review of, these issues.

Legal advisors the Goldfields Gas Pipeline and the Victorian Gas Transmission System - benchmarking of efficient forecast business costs - Keith provided independent expert advice on issues of cost efficiency and allocation key to access arrangement revisions.

National Transport Commission – Forward Looking Cost Base Discussion Paper – Keith wrote and presented a paper that examined the potential characteristics of how a forward looking cost base could be applied to determine charges for the use of the roads network by heavy vehicles.

Water Utility – Cost allocation and capitalisation. Keith led a small team that developed options for QUU to refine and redevelop its cost allocation and capitalization policies to better meet a range of regulatory, financial reporting and operational objectives.

Legal advisors to Telstra Corporation - Fixed Line Services pricing Model (FLSM). Keith was the joint author of an expert report on the operation integrity and fitness for purpose of the ACCC's FLSM.

Major telecommunications provider - Keith led a KPMG team that undertook economic and financial analysis to help determine whether access prices provide sufficient margins to facilitate competition.

Department of Infrastructure and Transport – Costing of Security ID card provision – Keith led a team that costed service provision