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Confidential Communication

Dear Mr Wright

Fixed line services review – request for further information

I am writing in response to your letter dated 17 May 2011. In that letter you requested information in relation to Telstra's demand forecasts for fixed line services and the Tax value of Telstra's assets. Telstra's response to your request is set out below.

Telstra's response includes a claim of confidentiality in respect of certain information (including information in Appendix A and Appendix B). The confidential information is identified in either red type and yellow highlighting or black type and red highlighting.

Telstra nominates the confidential information identified in red type and yellow highlighting as 'confidential information' under Attachment 1(c) of the existing confidentiality undertakings and will include this information in the confidential version of our formal submission to the Commission's Discussion Paper.

Telstra submits the information identified in black type and red highlighting for the Commission's use only and considers it inappropriate for disclosure under the confidentiality regime. This information is commercially sensitive and should not be disclosed, other than to the ACCC.

1. **ACCC's request for "*forecasts of total demand for fixed line services, including changes in the number of SIOs in each band for each year of the regulatory period*" and "*updated demand forecasts for the declared fixed line services consistent with forecasts of total fixed line services demand*".**

Telstra previously wrote to the ACCC on 18 May 2011 setting out Telstra's demand forecasts for 2010/11, 2011/12 and 2012/13. In doing so, Telstra noted that those demand forecasts were based on the best information currently available to Telstra and that those forecasts are directly relevant to any determination that the ACCC may make in connection with the pricing of declared wholesale fixed line services.

Telstra has not forecast SIOs in each band. However, Telstra notes that in the FLSM, the ACCC currently uses the distribution of SIOs as at 2009/10 for each year thereafter. In the context, Telstra considers that this is a reasonable approach, if the ACCC calculates the average prices for CAN services on the basis of total SIOs. Telstra does not forecast demand for years beyond 2012/13. Telstra suggests the ACCC continue the trends apparent from 2011/12 to 2012/13 to determine forecast demand in future years.

2. **ACCC request for "*an explanation of the assumptions and other information used to develop these forecasts*"**.

Telstra has previously set out the demand forecasting process and assumptions,[1] and points the ACCC to that previous material. Further, at the time Telstra provided earlier forecasts to the ACCC in November 2010, Telstra expected that LSS would continue to grow consistently with historical trends. [c-i-c commences] [redacted] [c-i-c ends]

3. **ACCC request for "*the tax depreciated asset values and accumulated tax depreciation by FLSM asset class as at 1 July 2009, calculated in a manner consistent with the assets included in the FLSM asset classes*".**

Telstra sets these out in Appendix A. Two tables are illustrated – the first table groups assets consistent with Telstra's previous submissions, and the second table groups assets consistent with the way the ACCC has grouped them in the FLSM. For both tables, Telstra has included/excluded the same assets as set out in Schedules 1 and 2 in Telstra's submission dated November 2010 responding to earlier ACCC questions. Both tables in Appendix A also compare the tax values of assets to their accounting values.

4. ACCC request for "*the tax depreciation method used to calculate the tax depreciated asset values and accumulated tax depreciation for each FSLM asset class. Where a different methodology applies to specific asset/s within an asset class, a breakdown of the values and asset lives for these individual assets should be provided.*"

[1] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, section 5.5.2.

Telstra generally uses the diminishing value method as the standard depreciation method for tax purposes for all assets acquired up to 30 June 2010. Any assets acquired after this date are generally depreciated under the prime cost method. These policies apply unless a specific tax legislative rule requires us to use a specific method. For instance:

- Telstra is required to use the prime cost (straight line) method for software assets, which make up approximately [c-i-c commences] [redacted] [c-i-c ends] of the total accounting value of assets included in the FLSM;
- Telstra does not depreciate land for tax purposes;
- Telstra does not depreciate network buildings purchased in 1981/82 and prior, which makes up [c-i-c commences] [redacted] [c-i-c ends] of the tax WDV value of network building assets included in the FLSM and set out in the Appendix A;
- Telstra is required by legislation to depreciate the other [c-i-c commences] [redacted] [c-i-c ends] of the tax WDV of network buildings using a straight line method at a 2.5% rate; and,
- Assets purchased after 30 June 2010 are depreciated using the prime cost method.

For assets purchased prior to 10 May 2006, the standard diminishing value formula that Telstra applies is as follows:[2]

$$Diminishing\ Value\ Depreciation = Written\ Down\ Value \times \frac{Days\ Held}{365} \times \frac{150\%}{Effective\ Life}$$

Following legislative changes to allowable depreciation methodologies, for assets purchased between 10 May 2006 and 30 June 2010, the standard diminishing value formula that Telstra applies is as follows:

$$Diminishing\ Value\ Depreciation = Written\ Down\ Value \times \frac{Days\ Held}{365} \times \frac{200\%}{Effective\ Life}$$

[c-i-c commences] [redacted] [c-i-c ends]

Telstra has set out proposed depreciation methodologies to use for each asset category in the FLSM in Appendix B.

Telstra has elected to use the Low Value Pool rules which requires Telstra to allocate assets with a tax WDV of less than $1,000 (Low Value assets) or tax cost of less than $1,000 (Low Cost assets) into a tax depreciable pooled asset.[3] Low Value and Low Cost assets are depreciated using the diminishing value method, with a depreciation rate set to 37.5% (18.75% for the first year of Low Cost assets). By contrast, the accounting rule is to immediately expense additions with a cost less than $500, resulting in tax deductions claimed after the book expense in many cases. As at 30 June 2010, the tax WDV of Low Value and Low Cost assets was [c-i-c commences] [redacted] [c-i-c ends] of the total tax WDV of all assets.

[2] http://www.ato.gov.au/businesses/content.aspx?doc=/content/66033.htm&page=17&H17
[3] http://www.ato.gov.au/Individuals/content.aspx?menuid=0&doc=/content/00237833.htm&page=15

5. ACCC request for "*the average remaining asset lives for tax purposes for each FLSM asset class*" and "*if depreciation has been accelerated for tax purposes by truncating asset lives, the calculations that were used to arrive at a weighted average remaining asset life should be shown*".

Under legislation Telstra has the option to reassess the tax effective lives of assets if circumstances change, however, Telstra very rarely reassesses the tax effective lives of installed assets for tax purposes after they are on the books.

Telstra has assessed the feasibility of the ACCC's request for remaining asset lives for tax purposes. Telstra would be required to calculate the remaining assets lives from information in its accounts. However, there are many inputs into such a calculation and different methodologies that could be adopted. For instance, there are many different asset classes, each can be attributed with different effective lives, different vintages of assets within the same asset class can have different effective lives, and they can have different diminishing value formulas applied to them (as discussed above). Given the size of Telstra's network assets and the wide ranging differences in effective lives of each of these assets, any average effective life input into the FLSM may be meaningless, because material segments of Telstra's network will have differing effective lives and be depreciated in practice beyond the average effective life. Any resulting estimate based on this average effective life will likely result in the benefit of estimated tax depreciation deductions being claimed much earlier in the FLSM than in practice. This would make it difficult for Telstra to verify or stand by the accuracy of any calculation of remaining life, within the timeframe of responding to the ACCC's letter.

Further, it is not clear to Telstra for what purpose the ACCC has requested information in relation to the remaining service lives of assets for tax purposes. So long as the tax WDV of assets is accurately reflected in the FLSM, then the overall amount of tax depreciation deductions that are made in the FLSM will be similar to the overall amount of tax depreciation deductions that Telstra can make in practice.

If Telstra could better understand the purpose for which the information would be used, then Telstra might be able to provide other information available to Telstra that may properly address the ACCC's query.

6. ACCC states "*Telstra's views on how to accommodate this approach within the FLSM should be provided*" and "*Telstra should demonstrate that the proposed approach would not result in an over recovery of depreciation over the remaining life of the asset*".

Telstra expects its actual tax depreciation to be calculated using the same diminishing value and prime cost methods as described above for the majority of assets included in the FLSM. The material exceptions to this are land and building assets as discussed above.

With respect to assets included in the FLSM, Telstra will seek to deduct from income the total value of tax WDV set out in Appendix A, except for land and a proportion of buildings. Therefore, if the FLSM appropriately recognises the same tax value of assets, then the FLSM should make the same overall deductions from income as Telstra does in practice.

However, the following three factors will affect the timing of those deductions: (1) whether assets are depreciated on the basis of the diminishing value method with an uplift of 150%

or 200% or prime cost method; (2) if and when assets are allocated to a Low Value Pool; and (3) whether the assets are software assets.

In relation to the first point, [c-i-c commences] [redacted] [c-i-c ends] To approximate the timing of Telstra's tax depreciation deduction, Telstra proposes that the ACCC assumes that [c-i-c commences] [redacted] [c-i-c ends] of tax assets (except land and building assets) are depreciated for tax purposes on the basis of the first diminishing value formula above (with a 150% rate) and that [c-i-c commences] [redacted] [c-i-c ends] of the tax assets are depreciated for tax purposes on the basis of the second diminishing value formula above (with a 200% rate). Any assumed additions beyond 1 July 2010 should be depreciated for tax purposes using the prime cost method. In relation to the second point, [c-i-c commences] [redacted] [c-i-c ends] of the total tax WDV of all assets were allocated to a Low Value Pool as at 30 June 2010. This is unlikely to make a material difference to the timing of tax depreciation deductions. In relation to the third issue only approximately [c-i-c commences] [redacted] [c-i-c ends] of the total accounting value of assets included in the FLSM are software assets. Again, this is unlikely to make a material difference to the timing of tax depreciation deductions.

Telstra notes that the FLSM has the option to calculate diminishing value tax depreciation, but only for new capex. The following steps would need to be taken by the ACCC to appropriately reflect diminishing value tax depreciation for existing assets based on Telstra's tax value of assets as in Appendix A:

1. Adjust the tax value of assets in Table 4.1 of the FLSM to reflect the tax value of assets as set out in Appendix A, noting that only the depreciable proportion of building assets should be included;

2. Set the depreciation method for CAN and Core assets to "Diminishing Value 150%" in table B.1 of the FLSM;

3. Change the values in cells F16 and F17 in table B.1 of the FLSM so that the 150% diminishing value rate is applied to [c-i-c commences] [redacted] [c-i-c ends] of the tax WDV of assets and the 200% diminishing value rate is applied to the remaining [c-i-c commences] [redacted] [c-i-c ends] of the tax WDV of assets; and,

4. Copy the formula that determines the asset life and tax depreciation amounts in table 9.3.3 of the FLSM (which applies to new capex), and paste the same formula in the corresponding cells in table 9.3.1 (which applies to existing capex);

5. Set the depreciation approach for Network Buildings/Support to a straight line approach; and,

6. Set the depreciation approach for assets purchased after 30 June 2010 to a straight line approach.

Telstra considers that these steps will mean that the tax expenses calculated in the FLSM will closely approximate Telstra's actual tax expenses relating to the same assets covered by the FLSM.

Telstra has responded to the ACCC's queries on the tax value of assets as best it is able in the time that the ACCC has provided. Telstra may seek to provide further information to the ACCC and/or make additional submissions on these issues as part of its response to the ACCC's Discussion Paper.

Should the ACCC have any further queries in relation to the demand or tax value of assets issues discussed above, please let me know.

Yours sincerely,

Christine Williams
Acting Executive Director – Regulatory Affairs
Strategy & Corporate Services

Appendix A

Network Type	RAB Asset Code	[redacted]
CAN	CAN OTHER CABLES	
CAN	CAN RADIO BEARER	
CAN	CAN RADIO SYSTEMS	
CAN	DISTRIBUTION CABLES	
CAN	DISTRIBUTION DUCTS & PIPE	
CAN	MAIN CABLES	
CAN	MAIN DUCT OR PIPE	
CAN	MUX	
IEN	IEN CABLE	
IEN	IEN RADIO BEARER	
IEN	PDH TRANSMISSION	
IEN	SDH TRANSMISSION	
IEN	SWITCHING EQUIPMENT - LOCAL	
IEN	SWITCHING EQUIPMENT - OTHER	
IEN	SWITCHING EQUIPMENT - TRUNK	
IEN	TRANSMISSION EQUIPMENT	
NETWORK SUPPORT	NETWORK BUILDINGS	
NETWORK SUPPORT	NETWORK LAND	
NETWORK SUPPORT	NETWORK POWER	
NETWORK SUPPORT	NETWORK SUPPORT	
Total		

FLSM Code	RAF/RAB Code	[redacted]
Ducts and pipes	CAN Ducts and Pipes	
Copper cables	CAN Copper Cables	
Other cables	CAN Other Cables	
Pair gain systems	CAN Pair Gain Systems	
CAN Radio Bearer Equipment	CAN Radio Bearer Equipment	
Other CAN assets	Other CAN	
Switching Equipment - Local	Switching Equipment - Local	
Switching Equipment - Trunk	Switching Equipment - Trunk	
Switching Equipment - Other	Switching Equipment - Other	
Inter-exchange Cables	Inter-exchange Cables	
Transmission Equipment	Transmission Equipment	
CORE Radio Bearer Equipment	Radio Bearer Equipment	
Other Communications Plant and Equip.	Other Communications	
Network Land	NETWORK LAND	
Network Buildings/Support	NETWORK BUILDINGS	
	NETWORK POWER	
	NETWORK SUPPORT	
	Total	
Indirect Capital Assets		
Total		

Notes:

(1) The following notation is used: Written Down Value (WDV); Accumulated Depreciation (AD); Accounting (Acc).

(2) Values are in millions of dollars.

(3) The "difference" for Indirect Capital Costs is equal to the total difference between tax and accounting WDV for all other assets.

Appendix B

Proposed tax depreciation method for assets purchased on or prior to 30 June 2010:

FLSM Code	RAF/RAB Code	Proposed Tax Depreciation Method
Ducts and pipes	CAN Ducts and Pipes	Diminishing value
Copper cables	CAN Copper Cables	Diminishing value
Other cables	CAN Other Cables	Diminishing value
Pair gain systems	CAN Pair Gain Systems	Diminishing value
CAN Radio Bearer Equipment	CAN Radio Bearer Equipment	Diminishing value
Other CAN assets	Other CAN	Diminishing value
Switching Equipment - Local	Switching Equipment - Local	Diminishing value
Switching Equipment - Trunk	Switching Equipment - Trunk	Diminishing value
Switching Equipment - Other	Switching Equipment - Other	Diminishing value
Inter-exchange Cables	Inter-exchange Cables	Diminishing value
Transmission Equipment	Transmission Equipment	Diminishing value
CORE Radio Bearer Equipment	Radio Bearer Equipment	Diminishing value
Other Communications Plant and Equip.	Other Communications	Diminishing value
Network Land	NETWORK LAND	Not depreciated
Network Buildings/Support	NETWORK BUILDINGS	Straight line rate of 2.5%
	NETWORK POWER	Diminishing value
	NETWORK SUPPORT	Diminishing value
	Total	
Indirect Capital Assets		Diminishing value

Proposed tax depreciation method for assets purchased after 30 June 2010:

FLSM Code	RAF/RAB Code	Proposed Tax Depreciation Method
Ducts and pipes	CAN Ducts and Pipes	Straight Line
Copper cables	CAN Copper Cables	Straight Line
Other cables	CAN Other Cables	Straight Line
Pair gain systems	CAN Pair Gain Systems	Straight Line
CAN Radio Bearer Equipment	CAN Radio Bearer Equipment	Straight Line
Other CAN assets	Other CAN	Straight Line
Switching Equipment - Local	Switching Equipment - Local	Straight Line
Switching Equipment - Trunk	Switching Equipment - Trunk	Straight Line
Switching Equipment - Other	Switching Equipment - Other	Straight Line
Inter-exchange Cables	Inter-exchange Cables	Straight Line
Transmission Equipment	Transmission Equipment	Straight Line
CORE Radio Bearer Equipment	Radio Bearer Equipment	Straight Line
Other Communications Plant and Equip.	Other Communications	Straight Line
Network Land	NETWORK LAND	Not depreciated
Network Buildings/Support	NETWORK BUILDINGS	Straight line rate of 2.5%
	NETWORK POWER	Straight Line
	NETWORK SUPPORT	Straight Line
	Total	
Indirect Capital Assets		Straight Line