TELSTRA CORPORATION LIMITED

PUBLIC INQUIRY TO MAKE FINAL ACCESS DETERMINATIONS FOR THE DECLARED FIXED LINE SERVICES

PART A OF TELSTRA'S RESPONSE TO THE COMMISSION'S DISCUSSION PAPER

June 2011

TABLE OF CONTENTS

1. TELSTRA CANNOT RECOVER THE VALUE OF ITS INVESTMENTS UNDER THE COMMISSION'S APPROACH

1.1. The Commission's initial RAB does not reflect the value of Telstra's network assets

1.1.1. OVERVIEW

1. The Australian Competition and Consumer Commission (**Commission**) is proposing to transition to a building block model (**BBM**) for setting prices for the fixed line services. Under a BBM, prices are set on the basis of component costs (building blocks) including, importantly, a return on and return of capital invested in providing those services. The value ascribed to capital investment in network facilities is referred to as the regulatory asset base (**RAB**).

2. The RAB in the building blocks framework is the economic value attributed to Telstra's investments in the Customer Access Network (**CAN**) and Inter Exchange Network (**IEN**), which are used in providing the declared fixed line services. Prices are set on the basis of an allocation of the value of the CAN and IEN investments to the declared services.

3. In making an access determination which sets prices for declared fixed line services, the Commission is required to have regard to, amongst other matters, the long term interests of end users (**LTIE**) (including relevantly, encouraging efficient use of and investment in relevant infrastructure); the legitimate business interests of the carrier supplying the declared services (ie.Telstra) and Telstra's investment in facilities to supply declared services.[1] Telstra submits that in line with the legislative criteria, the purpose of the Commission's inquiry should be to establish an initial RAB valuation which reflects the current economic value of Telstra's fixed line assets.

4. To date, prices for ULLS, LSS and PSTN OTA have been set on the basis of the principles published in the *Access Pricing Principles – Telecommunications: a guide* (**1997 Access Pricing Principles**), issued following the introduction of regulated access pricing under the then new Part XIC of the *Trade Practices Act 1974* as the *Competition and Consumer Act 2010* was then known. The 1997 Access Pricing Principles adopted a TSLRIC+ approach to setting regulated access prices.[2]

5. The value ascribed to Telstra's network investments under the 1997 Access Pricing Principles was a forward-looking optimised replacement cost. The characteristics and the properties of an optimised replacement cost valuation approach and their consistency with the relevant legislative criteria that the Commission was required to have regard to were discussed and considered in the 1997 Access Pricing Principles.[3]

6. Prices for WLR and LCS were set on a retail minus retail cost (**RMRC**) basis, in which the access price is determined by deducting Telstra's avoidable costs of retailing a given service to end users from the retail price charged by Telstra for that service. The RMRC approach was adopted in the context of a regulated retail price that was below Telstra's costs of providing the service; such that the Commission considered that if a cost based price had been set, there would be no prospect for competition based on use of the LCS.[4] The prices

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[1] Section 152BCA(1) of the *Competition and Consumer Act 2010* (Cth).

[2] ACCC, *Access Pricing Principles: Telecommunications - A Guide*, 31 July 1997, p. 28.

[3] ACCC, *Access Pricing Principles: Telecommunications - A Guide*, 31 July 1997, pp. 28-30.

[4] ACCC, *Local Carriage Service Pricing Principles and Indicative Prices: Final Report*, April 2002, p. 2.

set by the Commission for WLR and LCS in effect implied a value for the assets used in providing those services, albeit a value below cost.

7. The process of changing from one valuation methodology to another should not bring about a substantial change in the assessed value of the underlying assets or the price for access. Any substantial change would indicate either a problem with the application of the previous methodology or a problem with the application of the new methodology (or both) and it would certainly be a matter calling for investigation. Yet in the present case, the Commission is proposing a substantial and irreversible reduction in the value of Telstra's investment in the CAN and the IEN, without attempting to reconcile or justify the disparity between the old methodology and the new.

8. In setting the value of the RAB in the transition from the TSLRIC+ methodology under the Commission's 1997 Access Pricing Principles, Telstra submits that the Commission must consider and give real weight to:

   (a) Telstra's legitimate business interests in recovering through prices for declared services the economic value of its investments, in circumstances where the proposed approach of the Commission does not achieve this, and indeed is not apt to achieve this;

   (b) the failure of the Commission's proposed approach to promote LTIE of the services in question, or the economically efficient operation of the network, by virtue of:

      (1) its failure to assess an appropriate economic value of the assets in question;

      (2) its failure thereby to send appropriate investment signals to either third parties or to Telstra, including in relation to innovation and the development of new technologies;

      (3) the impact on the incentives for investment in infrastructure if simply by reason of a change in regulatory methodology there is a substantial reduction in the value ascribed to an Access Provider's investment;

   (c) its previous approach to setting prices and the implied depreciated asset valuations reflected in its past decisions; and

   (d) Telstra's legitimate business interest in not being subject to *ad hoc* and arbitrary changes in the value of its investment, simply by reason of a change in the regulatory methodology for setting prices.

9. Telstra submits that in setting the initial RAB under the transition to a building blocks methodology, the Commission has not yet given proper consideration to these relevant matters.

10. It is apparent that the Commission has determined the draft initial RAB value, by:

   - back solving an asset value based on the application of only one price, the ULLS Band 2 price set by the Commission in its 2008/2009 pricing principles review[5] applied across Bands 1 to 3;

   - checking the resulting asset value against the residual regulatory accounting values in Telstra's regulatory accounts for its CAN and IEN assets (and indexing the nominal accounting values for land to derive a real land value); and

[5] ACCC, *Unconditioned Local Loop Service: Pricing Principles and Indicative Prices*, June 2008, p. 22. The ULLS prices established for 2008-09 were subsequently rolled over for 2009-10.

- ascribing the differential between the ULLS Band 2 price determined valuation and its land indexed adjusted accounting value to the ducts and pipes asset category.

11. In doing so, the Commission has proceeded on the incorrect basis that:

    - it could not reasonably apply past replacement cost valuations and/or it was appropriate to give no meaningful consideration to past (replacement cost) valuations and the value of Telstra's investments as reflected in past regulatory decisions;

    - use of a depreciated actual cost (**DAC**) floor was sufficient to protect Telstra's legitimate business interests, as it would allow Telstra to recoup its actual investment costs and achieve a commercial return on those investments. This in turn rested on the assumption that the transition from TSLRIC+ with back loading of depreciation to a BBM with straight line depreciation would not result in under recovery as Telstra was likely to have over-recovered historic costs;

    - if historic costs are to be used, it was appropriate to rely on unindexed historic costs (and therefore indexed historic cost estimates could be ignored), since Telstra has been compensated for inflation in the past through nominal returns; and

    - having set a DAC floor it was largely free to set an asset value above that floor without further regard to Telstra's legitimate business interests and its past regulatory approach and in doing so it was appropriate to set the asset value by reason of consideration of only one factor - the investment of Access Seekers in digital subscriber line access multiplexer (**DSLAM**) infrastructure in Band 2 exchanges.

12. In transitioning from the previous methodology to a BBM, the Commission should give meaningful consideration and real weight to the valuation provided by Telstra of its investments based on the anticipated declared fixed line service revenues and prices that Telstra could reasonably expect under the prior regulatory framework. This was the clearest candidate for valuation which would allow Telstra to recover the value of its investment as at the point of that transition from one regulatory methodology (TSLRIC+) to another (BBM). Such a valuation is consistent with the basis on which prices have been set for the relevant declared fixed line services since the introduction of the regulatory framework for provision of access to declared services in 1997.

13. It appears that the Commission has considered the question of the starting value as largely a theoretical exercise of determining a range of asset values, with only limited consideration of the relevant context for the setting of the RAB in a transition to the building blocks methodology.

14. As a consequence, the Commission has substantially reduced the real value of Telstra's investment in the CAN and IEN. Telstra submits that such an outcome based merely on the change from one regulatory methodology to another, without other independent justification, is of itself unreasonable.

1.1.2. THE COMMISSION SHOULD ADOPT A STARTING VALUATION REFLECTING THE ECONOMIC VALUE OF TELSTRA'S INVESTMENT

Key points:

Telstra has a legitimate interest in recovering the economic value of its fixed line investments.

The most appropriate means of measuring economic value in this context is to apply a DORC valuation.

The written down accounting value of historic capital expenditure is not relevant to economic value in this context.

1.1.2.1. TELSTRA HAS A LEGITIMATE INTEREST IN RECOVERING THE ECONOMIC VALUE OF ITS FIXED LINE INVESTMENTS

15. Telstra submits that it, like any other infrastructure owner, has a legitimate interest in recovering the remaining economic value of its fixed network investments. This proposition should be uncontroversial and it has been consistently recognised by economists[6], regulators[7] and courts.[8] For example, the Australian Competition Tribunal (in a decision later upheld by the High Court) has described the exercise of asset base valuation thus:[9]

> *…the primary quest is for a proper contemporaneous value from which to deduce a tariff that will replicate a hypothetical competitive market. It is not to provide subsidies to customers. Pricing below a tariff based upon true value would not replicate a competitive market.*

16. As the Commission has previously recognised, the main economic principle for assessing the economic value of any asset is that its value to investors is equal to the present value of the expected future cash flows generated by those assets.[10]

17. In a regulatory context, valuation by reference to future cash flows can create a conundrum since the asset valuation will be an input into the regulator's determination of future prices (and thus cash flows). However in this case no such conundrum exists because price regulation has been applied to fixed line services for more than a decade. Previous regulation has established a path for future cash flows and a valuation for Telstra's fixed line assets.

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[6] Alfred E Kahn (1988), *The Economics of Regulation: Principles and Institutions*, 4th ed, MIT Press, pp. 35 -41.

[7] For example, the ACCC recognised that under TSLRIC+, asset valuation was necessarily based on "economic cost" (ACCC, *Access Pricing Principles – Telecommunications: a guide*, July 1997, p 41). The ACCC similarly recognised the importance of determining "economic value" of assets in the context of electricity network regulation (ACCC, *Statement of principles for the regulation of electricity transmission revenues – background paper*, December 2004, p37). This same principle was recognised by the ACCC's predecessor AUSTEL in determining interconnection charges for Telecom/OTC (*AUSTEL study of arrangements and charges for interconnection and equal access: economic and commercial considerations: final report to the Minister for Transport and Communications*, 14 June 1991, p. 145).

[8] The High Court has recognised the importance of ascribing a *value* to the asset base, rather than simply recognising historic expenditure. In *EAPL v ACCC*, the High Court upheld the Tribunal's approach in *Re EAPL* (footnote 9 below), which endorsed a DORC valuation of assets. The High Court described the exercise of initial RAB valuation as follows: "Simply stated, the ultimate purpose of setting an ICB [initial Capital Base] is to calculate a Reference Tariff (reflecting economic efficiency) in respect of an investment. A Reference Tariff requires consideration of a rate of return on the value of the capital assets. A rate of return which is properly determined should not distort future investment decisions." (*East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* [2007] HCA 44, at [11]).

In the United States, courts have long recognised the importance of ascribing a "fair value" to assets in the context of utility regulation, with fair value to be established by reference to the present rather than original cost of construction (*Smyth v Ames* 169 U.S. 466 (1898), quoted in Kahn (1988), fn 6 above).

[9] *Application by East Australian Pipeline Limited* (2004) ATPR ¶42-006 at 48,807.

[10] ACCC, *Statement of principles for the regulation of electricity transmission revenues – background paper*, December 2004, p 37.

1.1.2.2. THE MOST APPROPRIATE MEANS OF MEASURING ECONOMIC VALUE IN THIS CONTEXT IS TO APPLY A DORC VALUATION REFLECTING PAST COMMISSION VALUATIONS

18. Telstra's submission to the September 2010 Draft Report (**2010 Draft Report**) emphasised that the most appropriate measure of economic value in this context would be a depreciated optimised replacement cost (**DORC**) valuation based on the remaining value of Telstra's fixed line assets at the conclusion of the TSLRIC+ regime.[11] Such a valuation would:

    (a) reflect the most recent forward-looking estimates of the economic value of Telstra's fixed line assets undertaken by the Commission;

    (b) be consistent with the overwhelming weight of regulatory precedent;[12] and

    (c) be consistent with valuations under the previous TSLRIC+ pricing regime.

19. This approach is supported by the expert opinion of Professor Sappington, who states:[13]

> *…in my opinion, the initial value for Telstra's RAB that best promotes the LTIE while serving the interests of access seekers and respecting Telstra's legitimate business interests is the most recent value set by the ACCC, modified to reflect any major relevant industry changes since the most recent valuation was set. This initial value for Telstra's RAB would retain consistency with the TSLRIC principles the ACCC has espoused since 1997 while facilitating a smooth transition to the new building block approach to setting access prices.*

20. The Commission does not appear to dispute the contention that a DORC valuation can be an appropriate measure of the remaining economic value of Telstra's asset base.[14] Rather, the Commission identifies certain issues which lead it to describe a DORC valuation as an "upper bound":

    (a) First, the Commission says that "[s]ince DORC values derived from existing models are based on continued use of outdated copper-based technologies, and less-than-full optimisation of the network, the ACCC considers that currently available DORC values form an upper bound for the range of suitable RAB values".[15]

    (b) Second, the Commission states that "use of a DORC valuation method would require the Commission to make many subjective judgements about the appropriate level of optimisation and the modern equivalent assets for the copper network."[16]

    (c) Third, the Commission observes that "if a suitable model was available, a DORC value would be calculated using a fibre network, with a discount for the much higher service quality potential of fibre and a substantial depreciation allowance to take into account the age and deterioration of the existing copper network (compared to a new fibre network)".[17]

21. This first observation made by the Commission echoes the approach in the 2010 Draft Report, summarised in the Discussion Paper as a view that "efficient 'build/buy' incentives

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[11] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 67-71.

[12] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, Schedule 4.

[13] *The ACCC's New Approach to Setting Access Prices: Opinion of Professor David E. M. Sappington*, 2 June 2011 (**Sappington Report**) (Schedule A1), p. 6.

[14] Indeed in the December 2009 Discussion Paper which initiated the inquiry into the 1997 Pricing Principles the Commission endorsed this approach to valuation (ACCC, *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services: Discussion Paper*, December 2009, p 37). In the most recent Discussion Paper, the Commission acknowledges that a DORC valuation would be compatible with the previous TSLRIC+ pricing regime and would be in line with regulatory precedent (Discussion Paper, pp. 54-55).

[15] Discussion Paper, p. 55.

[16] Discussion Paper, p. 55.

[17] Discussion Paper, p. 55.

promoted by a DORC approach are less relevant in the current environment of an aging copper network and the delivery of services across a variety of emerging technologies".[18] Telstra does not believe that this approach should be accepted or endorsed. The mere emergence of alternative technologies does not alter the rationale for a DORC valuation. If the price of access to the existing copper network was artificially discounted in this manner because of the possibility of replacement with emerging technologies, then there would be no incentive for those alternative technologies to be deployed – service providers would seek cheap access to the "outdated" network rather than developing alternative technologies, thereby stifling investment and innovation. It is inappropriate, as a matter of economic analysis and compliance with the legislative criteria, for the Commission to discount the price for access below that which reflects the value of relevant assets. But that is what the Commission has done in the present case, by treating DORC as the "upper bound" and confirming pricing by reference to a DAC valuation, which the Commission itself recognises does not reflect the economic value of the assets.

22. In relation to the second reason put forward, Telstra notes that the Commission has undertaken this task in the past and satisfied itself of the reasonableness of the resulting charges after consideration of the relevant inputs and optimisation assumptions. Telstra notes that the initial value of the asset base in the FLSM is dated 1 July 2009, so the timing of the optimisation necessary under a DORC valuation should be consistent with this. The Commission's versions of the models Telstra relies on to estimate DORC are optimised at approximately that time. As a result, there is no need to initiate a new round of consideration of optimisation and cost inputs. Rather, the Commission should rely on its past valuations and the price paths it has already set. Adopting a previous valuation methodology involves far less "subjective judgment" than the methodology outlined by the Commission in the Discussion Paper, for the reasons outlined below.

23. In relation to the third point raised by the Commission, Telstra notes that previous TSLRIC+ models (including TEA and Analysys) have accounted for the inclusion of fibre in the network design. For example one version of the Analysys model included around 92,000km of fibre sheath.[19]

24. Moreover, Telstra has doubts as to the Commission's claim that there would necessarily be a discount for the much higher service quality potential of fibre. As the Commission explained in its 1997 Access Pricing Principles, the appropriate method for determining the cost base is by "using best-in-use technology compatible with existing network design to measure cost".[20] There is no doubt that fibre is used, and commercially justified, in a broad range of applications (and existing models take fibre into account). However, it is by no means clear that the incremental valuation consumers place on fibre (relative to copper-based and wireless services) justifies deploying a ubiquitous fibre network in the immediate future, especially if that network must recover a capital charge that reflects the opportunity cost of capital.

25. In fact there is evidence to suggest that the net benefits of a fibre network over copper (and any associated "discount" off a copper network valuation) may be very small or even negative. Exhaustive analysis by McKinsey of the NBN suggests that such a network would be capable of earning little more than the bond rate.[21] This suggests that the incremental consumer valuation of the services that ubiquitous fibre could provide does not cover the incremental cost it involves, where that incremental cost includes the opportunity cost of capital (see Box 1).

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[18] Discussion Paper, p 52.

[19] Telstra, *Measure of TEA Model Efficiency: ULLS Band 2 – Version 2*, March 2009, p 6.

[20] ACCC, *Access Pricing Principles – Telecommunications: A Guide*, July 1997, p 30.

[21] McKinsey & Company, National Broadband Network Implementation Study, May 2010, p 359.

Box 1

Let the subscripts FN and CN refer to ubiquitous fibre and copper networks respectively and "B" and "C" to costs and benefits, so that TB and TC refer to total benefits and total costs, IB and IC refer to incremental benefits and incremental costs, and let SAC refers to stand-alone costs.

Consistent with the McKinsey Implementation Study:

$$TC_{FN(\text{valued at bond rate})} \leq TB_{FN} \leq TC_{FN(\text{valued at private sector opportunity cost of capital})}; \text{ and}$$

$$TB_{CN} \geq TC_{CN(\text{valued private sector opportunity cost of capital})},$$

where: $TC_{CN(\text{valued private sector opportunity cost of capital})} > TC_{CN(\text{valued at bond rate})}$.

Shortening "private sector opportunity cost of capital" to "opportunity cost of capital", it follows that:

$$TB_{FN} - TB_{CN} = IB_{FN} \leq TC_{FN(\text{at opportunity cost of capital})} - TC_{CN(\text{at opportunity cost of capital})} = IC_{FN}.$$

Assume regulated charges (RC) must be set such that in expectation RC ≥ TC, where, for economic efficiency and competitive neutrality, the cost of capital must reflect the private sector opportunity cost of capital. Let RC^{FN} be the regulated charge for the fibre network, and let it equal the sum of the contribution to cost recovery allocated to existing copper services, RC_{CN}, and of the contribution to cost recovery allocated to the new fibre services, RC_{FN}. For the capital maintenance condition to be met, it must be the case that:

$$TC_{FN} \leq RC^{FN} = RC_{FN} + RC_{CN} \leq TB_{FN} = TB_{CN} + IB_{FN}$$

However, if $IB_{FN} \leq IC_{FN}$, then, unless $RC_{CN} \geq SAC_{CN}$, it cannot be the case that the capital maintenance condition will be met. But if $RC_{CN} \geq SAC_{CN}$, end-users are plainly worse off than using the copper network as the basis for valuation.

1.1.2.3. THE WRITTEN DOWN ACCOUNTING VALUE OF HISTORIC CAPITAL EXPENDITURE IS NOT RELEVANT TO ECONOMIC VALUE IN THIS CONTEXT

26. The Commission considers that rather than relying on DORC, it should use DAC as a starting point for valuation. The Discussion Paper states that DAC has a number of advantages over DORC, including that it is widely accepted, objective and simple to implement.[22]

27. The proposition that DAC is widely accepted as an asset valuation methodology in the particular regulatory context is incorrect. As noted in Telstra's October submission to the 2010 Draft Report, regulatory precedent in this country is strongly in favour of forward-looking replacement cost methodologies, particularly DORC.[23]

28. The statement that DAC is objective is largely meaningless. Objectivity has to be by reference to a particular context, which in this case is in the valuation of the CAN and IEN. In that context, the selection of DAC involves substantial and complex subjective judgments as

[22] Discussion Paper, p. 53.

[23] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, Schedule 4.

to the past treatment of prices and investments (discussed in section 2.1.4 below) and its suitability as an appropriate basis for setting forward-looking prices. The fact that it is not a widely adopted asset valuation methodology is evidence that it is not an objective measure of the value of an investment.

29. As to simplicity, there is no reason to believe that a simpler methodology will provide a more appropriate valuation that is more appropriate in the context of the legislative criteria. That the Commission can "simply" look up asset values in a regulatory accounting framework does not render them appropriate for consideration as a value of Telstra's investments. Simplicity (given the risk that the decision is "simply" misguided) is not a valid consideration.

30. More generally, historic cost is a weak guide (and may not be any guide at all) to the economic value of an asset. For example the economic value of a house (unless it is brand new) may be very different to the amount represented by its historic purchase cost.

31. This problem is accentuated if historic costs are not indexed, as the impact of inflation alone renders the use of unindexed historic cost inappropriate. In this regard, it is important to note that if a BBM model had been used from the outset, the asset base would have been indexed by inflation over time.[24] As a result, the RAB today would be the inflation-indexed amount determined by that sequence of annual adjustments. In these circumstances, there can be no justification for using unindexed historic costs to calculate the opening RAB, or support a figure otherwise calculated for the opening RAB.

32. Further, the economic value of an asset is not necessarily affected by, or reduced by, the amount which has been recovered for the use of the asset in the past. For example, the historic purchase cost of a house may be less than what has been recovered through rents over time, but this does not mean the house has no value. Similarly, the fact that Telstra's assets may have been written down or even written out of the accounts does not mean they have reduced or no economic value for Telstra and reduced or no economic value in use for Access Seekers. Setting a very low (or zero) price for use of an asset simply because it has been written out of the accounts will not provide an accurate reflection of its economic value and will not send appropriate signals for its efficient use. For assets that have an alternative use (ie non-sunk assets), pricing below economic value is likely to encourage shifting of resources to other activities, even if these other activities are of a lesser economic value.

33. In the current context, Telstra submits that DAC in fact will be highly misleading as to the economic value of Telstra's fixed line assets. Economic value has been established through previous pricing decisions, which have been based on forward-looking valuations of the fixed line network. The effect of these decisions has been to de-link the network's value from the value of actual historic capital expenditure.

34. Accordingly, it is neither relevant nor necessary to determine precisely what, in decades past, previous owners recovered from the assets that now comprise Telstra's asset base. To the extent that there has been "over-recovery" in the past by previous owners of the business (principally the Government) it would hardly be appropriate to try to claw this back now through a devaluation of Telstra's asset base (just as it would be inappropriate to raise prices now to compensate for historic losses). This type of retrospective adjustment is precisely the type of regulatory opportunism that the Commission[25] says it is trying to avoid, and which Professor Yarrow warns against:[26]

> *…one risk is that such a rebalancing process might be taken too far, by setting the initial RAB in such a way that all past returns, up to the point of switching to the new pricing regime, are no*

[24] This appears to be the Commission's intention in respect of the new BBM. As noted by the Commission on pp 30-31 of the Discussion Paper, prices are to be calculated in real terms based on real asset valuations and then converted into nominal prices after the real price calculations have been completed. The Commission indicated that it will update the base year for real calculations in future periods.

[25] Discussion Paper, pp 53-54

[26] Professor George Yarrow, *RAB valuation for reformed pricing principles in telecoms*, October 2010 (**Yarrow Report**), p. 5.

more than normal. That is, the initial RAB might be set so that no economic profit (revenue in excess of all costs, including all capital costs) will have been mode over the past period, ie any past economic profit is 'clawed back'. Since capital markets might easily take the view that past economic losses would never likely be compensated for by this kind of retrospective adjustment, the danger of such ex post setting of net present value to zero (NPV = 0) is that it would contribute to a regulatory reputation for opportunism and for capital expropriation.

35. As previously submitted by Telstra, an important consideration for the Commission in the context of valuation is that the Government sold its shares in Telstra on the basis of recovering a fair value for those shares and investors acquired those shares on that same basis.[27] The fair value of those shares necessarily reflected the economic value of Telstra's assets, which in turn reflected the regulated prices and the regulatory principles for setting prices for the fixed line network at the time of privatisation.[28] Those principles did not simply provide for recovery of amounts of historic capital expenditure that had not been recovered by the previous owner (the Government), but rather were based on the forward-looking valuation of Telstra's fixed line network.

36. Notwithstanding that the impact on Telstra investors was raised in Telstra's earlier submission on the 2010 Draft Report[29], the Commission does not appear to have considered the implications for such investors of the change in its regulatory approach to a valuation model based on written down accounting values. While Telstra's investors were and are no doubt aware of the regulatory regime in which Telstra operates, the ACCC appears to have paid no regard to their interests in substantially devaluing Telstra's assets, other than to recognise that regulatory opportunism should be avoided.[30]

37. Importantly, the Commission does not claim that DAC will reflect economic value and in fact it is acknowledged that DAC may understate economic value.[31] Rather, the Commission states that the key property of a DAC valuation is that it would allow Telstra to recover its actual investment costs and achieve a commercial return.[32]

38. Putting to one side the issue of whether the Commission's DAC does in fact have this key property (addressed in section 1.1.4 below), it is not clear how recovery of historic capital expenditure is relevant to the determination of economic value in this case. In focusing on recovery of historic capital expenditure, the Discussion Paper suggests that the relevant test is whether Telstra would be better or worse off going forward than it would have been had historic costing rather than forward-looking costing been used over the past decade.[33] Stated somewhat differently, a relevant objective, and hence decision criterion, appears to be that of choosing a valuation base that places Telstra in a position no more favourable than it would have been in had the interlude of forward-looking costing never occurred. Telstra submits that this starting premise is flawed for at least three reasons.

39. First, the preceding decade or more of reliance on forward-looking costing cannot simply be set aside as the Commission seems to suggest. Indeed, it is difficult to understand how ignoring the Commission's own decisions, taken over a prolonged period of time, can be consistent with avoiding the "risk of regulatory opportunism" which the Commission itself argues could "deter future investments in sunk assets by regulated businesses".[34] Further,

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[27] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 20.

[28] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 20.

[29] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 20.

[30] Discussion Paper, p 54

[31] For example in respect of ducts and pipes, the Commission notes that "the economic value of these assets is likely to be substantially higher than their depreciated historic values as recorded in the RAF accounts" (Discussion Paper, p. 48).

[32] Discussion Paper, p. 54.

[33] Discussion Paper, p. 58.

[34] Discussion Paper, p. 54.

the Commission's approach ignores the decisions of the Tribunal which have endorsed a forward-looking replacement cost methodology.[35]

40. Second, the criterion of placing Telstra in the position in which it would have been had the interlude of forward-looking costing never occurred is incapable of being implemented. In particular, had the regulatory arrangements been different, Telstra's investment and output decisions would presumably themselves have been different. Those decisions would therefore have led to a RAB other than that the Commission now claims to find. As a result, the implication that the RAB reasonably approximates a 'but for' estimate is without foundation.

41. Matters in this respect are even more stark if it is assumed, for the sake of argument, that Telstra had been told at the outset of the forward-looking costing period, that after a decade of forward-looking costing, the RAB would have been set on the basis of unindexed depreciated accounting costs. In that event, Telstra would have had strong incentives to alter the timing and extent of its investment with a view to the setting of the RAB at the date of transition from forward-looking costing to a BBM.

42. As those incentives could not have promoted the efficient choice of investment, the rule implied by the Commission – a rule that can be paraphrased as "set the capital charge and prices on the basis of forward-looking costs for a decade, and then shift to a BBM using DAC as the basis for the RAB" – could not itself be efficient: for had it been foreseen, it would have impeded rather than encouraged economically efficient investment.

43. As a result, the only defence that could be made of that rule is that as a matter of fact it was not foreseen, for had it been pre-announced, it would have been inefficient and contrary to the legislative criteria. The fact that it was unforeseen only highlights the degree to which it involves a departure from reasonable expectations.

44. Third, even were the Commission's criterion accepted, the RAB would not be as the Commission claims. Rather, had the Commission's FLSM been implemented over the years, the asset base would have been indexed to inflation over time, with the asset valuation adjustment being reflected in the annual capital charge.[36] As a result, the RAB today would be the inflation-indexed amount determined by that sequence of annual adjustments.

45. In these circumstances, Telstra believes the Commission's approach to determining of the RAB valuation is flawed and restates its view that the initial RAB should be valued at DORC, reflecting the unexpired capital charges arising from the forward-looking cost models underlying the most recent Commission decisions. This approach:

    (a) is consistent with providing confidence in the value of regulatory principles and regulatory decisions;

    (b) does not require arbitrary and inherently subjective assessments of what Telstra's DAC would be "but for" the lengthy period of forward-looking costing, or of how the income stream to Telstra during that period compares to the income stream Telstra would have earned had access charges instead been regulated on the basis of DAC; and

    (c) is consistent with the price expectations the Commission's past decisions have signalled both to Telstra and to Access Seekers.

[35] For example, *Application by East Australian Pipeline Limited* (2004) ATPR ¶42-006; Application by Telstra Corporation Limited [2010] ACompT 1, at [239].

[36] This appears to be the Commission's intention in respect of the new BBM. As noted by the Commission on pp 30-31 of the Discussion Paper, prices are to be calculated in real terms based on real asset valuations and then converted into nominal prices after the real price calculations have been completed. The Commission indicated that it will update the base year for real calculations in future periods.

1.1.2.4. NBN ROLLOUT IS IRRELEVANT TO THE STARTING ASSET VALUE

46. It has been argued by some parties (including Telstra with respect to demand forecasts) that the Commission should consider the impact of NBNCo's deal with Telstra.

47. Telstra agrees with the approach taken in the Discussion Paper, which does not explicitly take the NBN deal into account. In light of the ongoing uncertainty around the details of NBN rollout and complexity of commercial negotiations surrounding the NBN, Telstra considers that it would be inappropriate to try to account for this. However, if NBN rollout was to be taken into account in setting the initial RAB value it would also need to be taken into account in other areas, such as demand forecasting and determination of asset lives.

1.1.3. TELSTRA HAS PROVIDED VALUATIONS WHICH REFLECT THE ECONOMIC VALUE OF ITS FIXED LINE ASSETS

Key points:

Telstra has put forward a DORC valuation which reflects the economic value of its fixed line assets.

The Commission has given insufficient consideration to this valuation proposal.

48. Telstra has previously provided calculations of the remaining value of its fixed line assets which could be used by the Commission to determine a value for the initial asset base. Calculations have been undertaken on the basis of both depreciated indexed historic cost (DIHC) and DORC. The alternatives put forward by Telstra[37] were:

    (a) a DORC valuation of $31 billion (comprising $16 billion for CAN assets, $14 billion for IEN assets and $1 billion for network land and buildings) based on the Telstra and Commission models most recently relied upon by the Commission to calculate TSLRIC+ prices; [38] and

    (b) a DIHC valuation of $28 billion (comprising $15 billion for CAN assets, $9 billion for IEN assets and $4 billion for network land and buildings) based on the historic cost accounts but with appropriate adjustments for inflation.[39]

49. Both of these valuations were reviewed by Dr John Small of Covec Ltd. Dr Small confirmed that Telstra's methodology and calculations were "appropriate and orthodox".[40] Telstra also provided the spreadsheets underlying these calculations to the Commission with its response to the 2010 Draft Report.

50. Telstra has clearly stated that its preference is for a DORC valuation. A DORC valuation would be consistent with previous valuations of Telstra's fixed line assets in past pricing decisions and would therefore promote regulatory certainty.[41] This is consistent with the expert opinion of Professor Yarrow who in his 2010 report on RAB valuation for reformed pricing principles in telecoms, emphasises the importance of regulatory consistency and "no mugging" in the transition from one pricing regime to another.[42] A DORC valuation as

[37] Telstra notes that an alternative valuation has been put forward by CEG on behalf of Optus. However, for the reasons set out in Schedule A.2 this alternative valuation is deeply flawed. Accordingly, this alternative should be given no weight by the ACCC.

[38] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 69-71,

[39] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 75-78; Telstra, *Documentation for indexed historic cost calculation*, October 2010,

[40] John Small (Covec Consulting), *Approaches to determining Telstra's regulated asset base*, October 2010.

[41] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 67-72.

[42] Professor George Yarrow, *RAB valuation for reformed pricing principles in telecoms*, October 2010.

proposed by Telstra would also be in line with the overwhelming weight of regulatory precedent.[43]

51. Telstra's approach to calculating DORC based on the value of Telstra's fixed line assets at the conclusion of the TSLRIC+ regime is in line with the recommendations of Professor Yarrow[44] and Professor Sappington[45] and has previously been endorsed by the Commission.[46] Telstra notes that the Commission does not appear to give proper consideration to the expert opinion of Professor Yarrow in this regard, besides noting his comments on the treatment of inflation (addressed in section 1.1.5 below).

52. However, if instead the Commission determines to use a standard consistent with historical costs, then Telstra submits that the historic cost values should be fully indexed in line with the approach proposed in Telstra's response to the 2010 Draft Report.[47] The reasons why indexation is necessary in this case are discussed in section 1.1.5 below.

53. The Discussion Paper does not include any substantive consideration of these valuation proposals.

1.1.4. THE COMMISSION'S DAC FLOOR SIGNIFICANTLY UNDERSTATES THE REMAINING ECONOMIC VALUE OF TELSTRA'S FIXED LINE ASSETS

Key points:

Telstra has previously provided evidence that written down accounting values are not intended to reflect the remaining economic value of its fixed line assets or past cost recovery and will in fact significantly understate this value.

The Commission acknowledges that written down accounting values are likely to overstate the extent to which Telstra has recovered the value of its newer assets under TSLRIC+ (and therefore understate remaining value).

The Commission erroneously, and without evidence, concludes that any under-recovery on newer assets under TSLRIC+ will be outweighed by over-recovery on older assets.

1.1.4.1. TELSTRA HAS PREVIOUSLY PROVIDED EVIDENCE THAT WRITTEN DOWN ACCOUNTING VALUES ARE NOT INTENDED TO REFLECT PAST COST RECOVERY

54. Although the Discussion Paper is not entirely clear in this regard, at an analytical level the Commission appears to treat historic cost recovery as a minimum threshold. Thus, the Discussion Paper states that the recovery of actual investment costs is a "lower bound" on any calculation, as a valuation method that valued sunk assets at less than their actual costs could, by creating a risk of "regulatory opportunism", deter future investments in sunk assets by regulated businesses.[48]

55. For the reasons set out in section 1.1.2 above, Telstra considers that the Commission's focus on recovery of historic capital expenditure misses the point of the RAB valuation exercise.

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[43] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp 50-54 and Schedule 4.

[44] Yarrow Report, p 9.

[45] Sappington Report (Schedule A.1), p. 6.

[46] ACCC, *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services: Discussion Paper,* December 2009, p. 37.

[47] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 77-78.

[48] Discussion Paper, p. 54. It should be noted that the Discussion Paper goes on to treat this lower bound as if it formed part of a reasonable range of values. In this regard, the Commission conflates a threshold or lower bound with an estimate.

The purpose of the Commission's inquiry should be to establish an initial RAB valuation which reflects the current economic value of Telstra's fixed line assets. The extent of recovery of historic costs is entirely irrelevant to the task. Therefore it is important to note that this section deals with a topic that the Commission should not be considering at all, namely the extent of previous cost recovery.

56. Putting aside Telstra's objection to the conceptual threshold set by the Commission, and even if recovery of historic capital expenditure were relevant, the Commission's DAC floor does not even ensure this. As a result, the DAC floor fails to meet its key objective of "allowing Telstra to recoup its actual investment costs and achieve a commercial return on those investments".[49] This is because:

    (a) it does not reflect the real purchase cost of Telstra's assets (section 1.1.5 below); and

    (b) it does not reflect the extent to which asset values have been recovered over time.

57. Telstra's submission to the 2010 Draft Report emphasised the fact that changing the basis of the valuation from forward-looking costs to accounting costs based on the regulatory accounting framework (**RAF**) would strand depreciation and prevent recovery by Telstra of its historic investment costs and, more importantly, the remaining economic value of its fixed line assets. Telstra highlighted the risks to cost recovery associated with moving from an annuity-based pricing approach to an approach based on depreciated accounting costs in its response to the 2010 Draft Report and a detailed technical appendix.[50]

58. Telstra emphasised that depreciation recorded in the RAF does not reflect (and is not intended to reflect) the extent to which Telstra's capital costs have been depreciated.[51] Depreciation recorded in the RAF is typically straight-line accounting depreciation, whereas since the implementation of TSLRIC+ pricing in 1997, prices have been based on a positively tilted annuity, under which much of the depreciation has been deferred to future years.[52]

59. Telstra's submission on the 2010 Draft Report was supported by expert evidence from Mr Bruce Porter, an accountant, on the treatment of depreciation under the relevant accounting standards (**Porter Report**).[53] The Porter Report demonstrates why the accounting values in the RAF do not reflect the remaining economic value of Telstra's asset base. Most importantly, the Porter Report states that under the relevant accounting standards, booked depreciation is not intended to reflect what has been recovered through prices.[54] The Porter Report further notes that the accounting practices used by Telstra (in line with the relevant standards) mean that depreciation recorded in the accounts will not reflect the economic value derived from Telstra's assets over time.[55]

60. It is clear from the Porter Report that the accounting values in Telstra's accounts do not reflect the way in which prices have been set over time, that is, they are not a measure of the residual unrecovered value of Telstra's investments.

61. It is also clear that prices have not been set over time so as to recover Telstra's nominal accounting depreciation. TSLRIC+ pricing was never intended to reflect any measure of the capital costs associated with the actual network, let alone the accounting depreciation

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[49] Discussion Paper, p 54.

[50] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 41-45; Telstra, *Asset valuation, depreciation and cost recovery* (Schedule 1 to Telstra's submission), pp. 10-11.

[51] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 45-46.

[52] Ibid, pp. 41-45.

[53] Bruce Porter, *Expert Advice Re: Use of Written Down Accounting Value of Fixed Network Assets*, 21 October 2010 (Schedule 2 to Telstra's submission on the Draft Report).

[54] Porter Report, p. 4.

[55] Porter Report, pp. 6-7.

recorded in respect of the actual network.[56] Rather, these prices were established by reference to an optimised network. This point was highlighted by both Telstra and Access Seekers in submissions on the 2010 Draft Report.[57]

62. Telstra further submits that there is no evidential basis to conclude that regulated prices have in fact allowed Telstra to recover its actual investments (and a commercial return on those investments) over time.

63. Telstra's submission to the 2010 Draft Report highlighted the fact that a large proportion of the asset base has been deployed since the introduction of TSLRIC+ pricing. For example, since 1999/2000, [c-i-c commences] [c-i-c] [c-i-c ends] of the total real cost of Telstra's 30 June 2010 CAN and IEN assets have been added ([c-i-c commences] [c-i-c] [c-i-c ends] in nominal terms).[58] For these assets, cost recovery has been entirely determined by TSLRIC+ pricing, with depreciation set on a tilted annuity basis rather than on an accounting basis. For other assets, the tilted annuity approach to cost recovery has applied for a significant part of their lives.

64. Telstra also submitted evidence to demonstrate that the RAF accounts will in fact overstate the extent to which asset values have been recovered through prices and therefore understate the remaining value of Telstra's asset base. Analysis undertaken by Telstra and presented in its response to the Commission's supplementary questions of November 2010 demonstrates that, for assets installed since 1999/2000, depreciation recorded in Telstra's accounts will significantly overstate what Telstra has been allowed to recover through prices. This analysis demonstrates over this period, that the Commission has allowed approximately [c-i-c commences] [c-i-c] [c-i-c ends] of regulatory depreciation to be recovered through prices, while accounting depreciation for the same assets was [c-i-c commences] [c-i-c] [c-i-c ends] (Figure 1).[59] The difference of [c-i-c commences] [c-i-c] [c-i-c ends] represents the amount of depreciation that has been deferred by the Commission in previous pricing decisions, and which would be effectively "stranded" by applying a DAC valuation based on unadjusted RAF asset values.[60] The Commission requested further information on these calculations in a letter to Telstra dated 11 November 2010, and Telstra provided this in a supplementary submission.[61]

Figure 1: [c-i-c commences] [c-i-c] [c-i-c ends]

65. Telstra also presented analysis of its real economic returns on fixed line services since 2007/08.[62] This analysis demonstrates that Telstra has not been allowed to over-recover over this period, relative to the asset values and amounts of depreciation recorded in the historic cost accounts. In fact, Telstra's real economic returns on wholesale services have been negative since 2007/08, indicating that over this period its revenues have not been sufficient to recover these amounts of depreciation taking asset inflation into account. The

[56] Refer to Schedule A.3 for details of the previous TSLRIC+ regime.

[57] For example, AAPT submitted that the straight line depreciation used in the RAF accounts should be replaced with a method which reduces the assets in those accounts by the actual compensation Telstra has received against those assets (*Submission by AAPT Limited to the Australian Competition and Consumer Commission's draft report titled Review of the 1997 telecommunications access pricing principles for fixed line services*, September 2010, p.3). The Competition Economists Group (CEG) in a report for Optus note that the depreciated historic costs in the RAFare unlikely to be adjusted for inflation and are not likely to use a method of depreciation that takes into account Telstra's historic compensation and so may either underestimate or overestimate what initial value is required to give fair compensation looking forward (CEG, *Past cost recovery and asset valuation: A report for Optus*, March 2010).

[58] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 43.

[59] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's request for further information*, November 2010, pp. 29-30. In reviewing these calculations, Telstra discovered a formula error in cells N32:N40 of Schedule 9 of Telstra's response to the ACCC's questions of November 2010. The effect of this error was to understate the extent of the shortfall. A corrected schedule 9 has been attached to this submission.

[60] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 43.

[61] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's request for further information*, November 2010, pp. 29-30.

[62] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 73.

Commission requested further information on these calculations in a letter to Telstra dated 11 November 2010, and Telstra provided this in a supplementary submission.[63]

66. Finally, Telstra's submission on the 2010 Draft Report noted that values in the RAF accounts will significantly understate the real historic cost of fixed line assets, since purchase costs are recorded in nominal terms and not indexed for inflation.[64] The Commission partially acknowledges this point in the Discussion Paper, and indexes land values accordingly.[65] However it is not clear why only land values are indexed, while historic costs for other assets are left in nominal terms. The hybrid RAB value - with land indexed and other asset values unindexed - is then used in the Fixed Line Services Model (**FLSM**) as a "real" asset valuation as at June 2009.[66] This asset valuation is clearly not "real" though, as it is based on the RAF accounts which record historic purchase costs in nominal terms. As a result, the prices derived from the FLSM will not properly compensate Telstra for its real historic investment costs.[67]

1.1.4.2. THE COMMISSION INCORRECTLY CONCLUDES THAT ANY UNDER-RECOVERY ON NEWER ASSETS UNDER TSLRIC+ WILL BE OUTWEIGHED BY OVER-RECOVERY ON OLDER ASSETS.

67. In the Discussion Paper and further correspondence, the Commission maintains its view that a DAC valuation based on the RAF accounts would allow Telstra to recover its investment costs, plus a commercial return.

68. The Commission acknowledges Telstra's arguments in relation to stranding of depreciation, at least in respect of recently deployed assets, noting that under a shift from TSLRIC+ with a titled annuity to a straight line depreciation BBM, Telstra will under recover, at least, the value of recent investments.[68]

69. However, the Commission considers that any under-recovery on newer assets is likely to be outweighed by over-recovery on older assets and therefore "on average" Telstra is unlikely to have under-recovered, relative to accounting depreciation.

70. The Discussion Paper states:[69]

> *The Commission considers that it is impossible to reach definitive conclusions about the level of Telstra's past cost recovery, that is, actual depreciation received on its assets, on the basis of the available data. However, the Commission considers that the available evidence suggests that Telstra is unlikely, on average, to have under-recovered depreciation on its network assets under the previous TSLRIC+ approach.*
>
> *Telstra's arguments about 'stranded' depreciation, made in its October 2010 submission, rest on an assumption that Telstra's assets were generally new when the TSLRIC framework commenced. The Commission considers that Telstra's assumption is not supported by the facts.*
>
> *If the majority of Telstra's assets were new when the TSLRIC framework commenced, it is possible that a move from the TSLRIC+ asset valuation approach (with a tilted annuity depreciation method) to a BBM methodology (with straight line depreciation) may lead to Telstra not recovering its investment costs.*

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[63] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's request for further information*, November 2010, pp. 37-39.

[64] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp. 54-56, 75-77.

[65] Discussion Paper, pp. 46-47.

[66] FLSM, sheet "2. RAB", cell E10.

[67] For example, for an asset purchased for $100 in 1999 which is half way through its life in 2009 (implying a depreciated value of $50 in the RAF accounts) the FLSM would only allow for recovery of $50 in 2009 terms over the remaining life of the asset, which amounts to around $39 in 1999 terms (assuming an inflation rate of 2.5%). If the remaining asset value is indexed, then the FLSM would allow recovery of the real depreciated historic cost (ie $50 in 1999 terms or $64 in 2009 terms).

[68] Discussion Paper, p. 58.

[69] Discussion Paper, p. 58.

However, many assets comprising Telstra's fixed line network were not new when the TSLRIC regime began… The older Telstra's assets were at the commencement of the TSLRIC framework, the greater the likelihood that the combination of the tilted annuity and revaluation of the asset base under the previous approach has resulted in net over-recovery of investment costs when moving from a TSLRIC+ methodology to a BBM approach.

71. Thus, the Commission concludes that Telstra is unlikely to under-recover in the shift from TSLRIC+ to building blocks with an accounting valuation of assets, at least "on average" (ie across all of its fixed line assets).

72. The Commission expresses the conclusion as being based on the consideration of the available evidence. No evidence is identified, nor is any explanation given about how such "evidence" might support the conclusion reached by the Commission.

73. This conclusion appears to rely on a number of assumptions, including that:

    (a) due to a combination of the tilted annuity and revaluation of the asset base under TSLRIC+, Telstra is likely to have over-recovered on assets that were in place prior to the implementation of TSLRIC+;

    (b) "on average" Telstra is unlikely to have under-recovered relative to accounting depreciation, since the majority of Telstra's asset base was not new when TSLRIC+ commenced (meaning that the Commission can effectively ignore the fact that accounting depreciation overstates actual recovery in the post-1999 period); and

    (c) under the previous TSLRIC+ regime, Telstra received a return on and of capital on assets that continued in use after they were fully depreciated.

74. In Telstra's submission, none of these assumptions are supported by the available evidence, and therefore the Commission cannot reasonably be satisfied that its shift in valuation methodologies will not result in under-recovery by Telstra of its actual investment costs. Each of these matters is addressed below.

1.1.4.2.1. "OVER-RECOVERY" ON OLDER ASSETS

75. With respect to assets purchased prior to 1999, there are two separate issues which are often conflated:

    (a) whether Telstra over-recovered on these assets prior to the introduction of TSLRIC+ pricing; and

    (b) whether Telstra achieved a windfall on these assets when TSLRIC+ was introduced (and subsequently through its return on and of capital), as a result of revaluation.

76. In respect of issue (a), the Commission states that it is difficult to reach a definitive conclusion regarding the precise level of recovery in the past (ie prior to the implementation of TSLRIC+), but says the "available evidence" suggests that Telstra has over-recovered in the past. The evidence referred to by the Commission is unclear.

77. It is not true to suggest that the evidence points to Telstra over-recovering prior to the implementation of TSLRIC+. On the contrary, the available evidence indicates that the extent to which Telstra was able to recover its costs was constrained by Ministerial oversight and then independent regulation for more than a decade prior to the introduction of TSLRIC+.[70] In some of its early pricing decisions under the telecommunications access regime, the Commission in fact noted that the retail price constraints that had been in place

[70] Detail of the relevant regulatory history is provided in Schedule 3.

since the 1980s had led to a situation where Telstra was unable to fully recover its line costs (referred to as the "access deficit").[71] This was one reason why retail-minus was initially applied to LCS, and later WLR – it was thought that TSLRIC+ may in fact be above the retail price for these services.[72] Later cost modeling by the Commission confirmed that RMRC prices for WLR were below cost.[73]

78. In respect of issue (b) above, the Commission asserts that for assets that were not new when the TSLRIC+ regime began, there is a "likelihood that the combination of the tilted annuity and revaluation of the asset base… has resulted in net over-recovery".[74] However this statement misrepresents the purpose of the TSLRIC+ regime and the role of the tilted annuity, and is at odds with the analysis presented in section 5.7 of the Discussion Paper.

79. The Commission's key rationale for using the tilted annuity in TSLRIC+ pricing was to prevent over-recovery. If applied consistently over time, the effect of a tilted annuity will be to offset any effect of revaluation in a forward-looking cost model. Where asset values are increasing over time, the application of a positive tilt which matches this trend will offset any revaluation gain through deferment of depreciation. The Commission has recognised this in the past, stating that in the context of increasing asset values, a positively tilted annuity will provide for fair compensation, while on the other hand a flat annuity will provide for over-recovery. The Commission has also recognised that the application of a positive tilt was intended to offset any "windfall" that may have been achieved through revaluation of assets. Therefore there is no reason to assume any over-recovery through the combination of TSLRIC and the tilted annuity.

80. This point is clearly articulated by the Commission in one of its early pricing decisions under the telecommunications access regime – its 2002 decision on ULLS pricing:[75]

> *The Commission uses a tilted annuity approach to depreciation that leads to a smoothed depreciation expense over the life of an asset. Telstra uses economic depreciation that produces a higher depreciation expense in the earlier years of an asset's life. The Commission is of the view that its approach prevents over-recovery of capital costs and more closely accords with a market-based pricing approach. The annuity approach also overcomes the 'year 1' problem that arises when using a forward-looking TSLRIC model, which assumes the network is brand new in each year which would result in higher asset values (and capital costs).*

81. The analysis in section 5.7 of the Discussion Paper reinforces this point. This analysis demonstrates that even for assets that were not new when TSLRIC+ commenced, a reversion to accounting costs at the conclusion of TSLRIC+ pricing is likely to lead to under-recovery (for example in figures 5.7 and 5.8 of the Discussion Paper). In the Commission's examples, it is only for assets that were very old when TSLRIC+ commenced that there is a hypothetical risk of past recovery being understated in the accounts. In fact, when TSLRIC+ commenced, many of Telstra's old assets were optimised out of the asset base, meaning that Telstra was not allowed any return on these assets at all.

1.1.4.2.2. RECOVERY "ON AVERAGE"

82. As is clear from the analysis set out above it is in fact not likely that there has been any over-recovery on "old" assets, and in fact it is more likely that there has been under-recovery. But whatever the position might be, an analysis of the treatment of "old" pre-1999

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[71] See, for example: ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p 59. The Commission found the access deficit to be around $1.2 billion in 2000-01.

[72] ACCC, *Local Carriage Service pricing principles and indicative prices: final report*, April 2002, p. 2.

[73] As noted in Telstra's submission to the Draft Report, the most recent TSLRIC+ estimates for WLR (from the Commission's Analysys model) indicated that the nationally averaged TSLRIC+ was well above the prevailing RMRC price (Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p 17 and Schedule 9).

[74] Discussion Paper p. 58.

[75] ACCC, *Pricing of unconditioned local loop services (ULLS): Final Report*, March 2002, p. 37.

assets can provide no rational basis to conclude that any over recovery off-sets the manifest (and accepted) under-recovery on new post-1999 assets.

83. As noted in Telstra's submission on the 2010 Draft Report, a significant proportion (around [c-i-c commences] [c-i-c] [c-i-c ends] in real terms, [c-i-c commences] [c-i-c] [c-i-c ends] in nominal terms) of Telstra CAN and IEN assets have been purchased since the TSLRIC+ regime commenced.[76] Of the remaining [c-i-c commences] [c-i-c] [c-i-c ends] of Telstra's real asset base, the vast majority was purchased in the decade leading up to the introduction of TSLRIC+ and was therefore relatively new when the regime commenced. Telstra's fixed asset register shows that just [c-i-c commences] [c-i-c] [c-i-c ends] of current CAN and IEN assets (in real terms)[77] were purchased prior to 1990, meaning that around [c-i-c commences] [c-i-c] [c-i-c ends] were either relatively new[78] when TSLRIC+ pricing commenced or were purchased during the operation of this pricing regime.

84. It is also worth noting that TSLRIC+ did not simply result in upward revaluation of Telstra's entire asset base, as the Commission appears to assume. Rather, TSLRIC+ involved valuation of an optimised asset base which did not include many of the assets that were in situ at the commencement of the regime. Many older assets were effectively "optimised out" and Telstra did not achieve any return on these assets during the TSLRIC+ regime. Previous optimisation studies have shown that the TSLRIC models used to determine prices under the old regime "optimised out" a significant proportion of Telstra's actual asset base. For example, Telstra's TEA model only costed around 65% of Telstra's actual trench length and around 45% of actual cable length.[79] The Commission's Analysys model also optimised out a substantial proportion of Telstra's asset base. As a result, Telstra is unlikely to have achieved any return on many of its older assets for which the Commission considers that there may have been a hypothetical prospect of over-recovery. For assets that were optimised out of the TSLRIC+ asset base, the path of cost recovery would have looked very different to the way in which it is portrayed in the Commission's Discussion Paper (see Figure 2 and Figure 3 below).

85. Therefore to the extent that Telstra benefited from revaluation under TSLRIC+ (and for the reasons above Telstra submits that this is not the case) this benefit would have been limited to a small class of assets. It therefore cannot be asserted that any "over-recovery" on these assets would outweigh the significant stranding of depreciation on newer assets.

[76] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p. 43.

[77] This equates to just [c-i-c commences] [c-i-c] [c-i-c ends] of current CAN and IEN assets in nominal terms.

[78] For example, for duct and pipe assets (the largest asset class by value), the full asset life assumed in the FLSM is 35 years. Therefore any duct and pipe assets purchased after 1990 would be no more than a third of the way through their life upon the introduction of TSLRIC+.

[79] Telstra, *Measure of TEA Model Efficiency: ULLS Band 2 – version 2*, March 2009, p. 6.

Figure 2: Remaining value of an "old asset" optimised out under TSLRIC+ (reworked Figure 5.11 from the Discussion Paper)

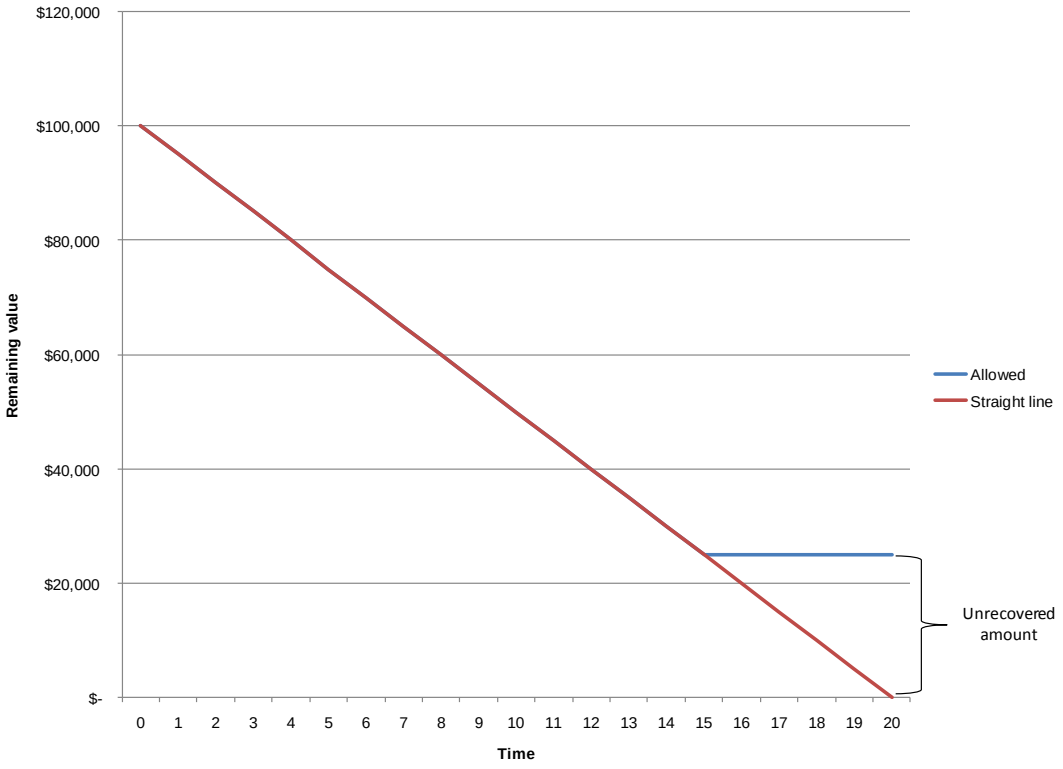
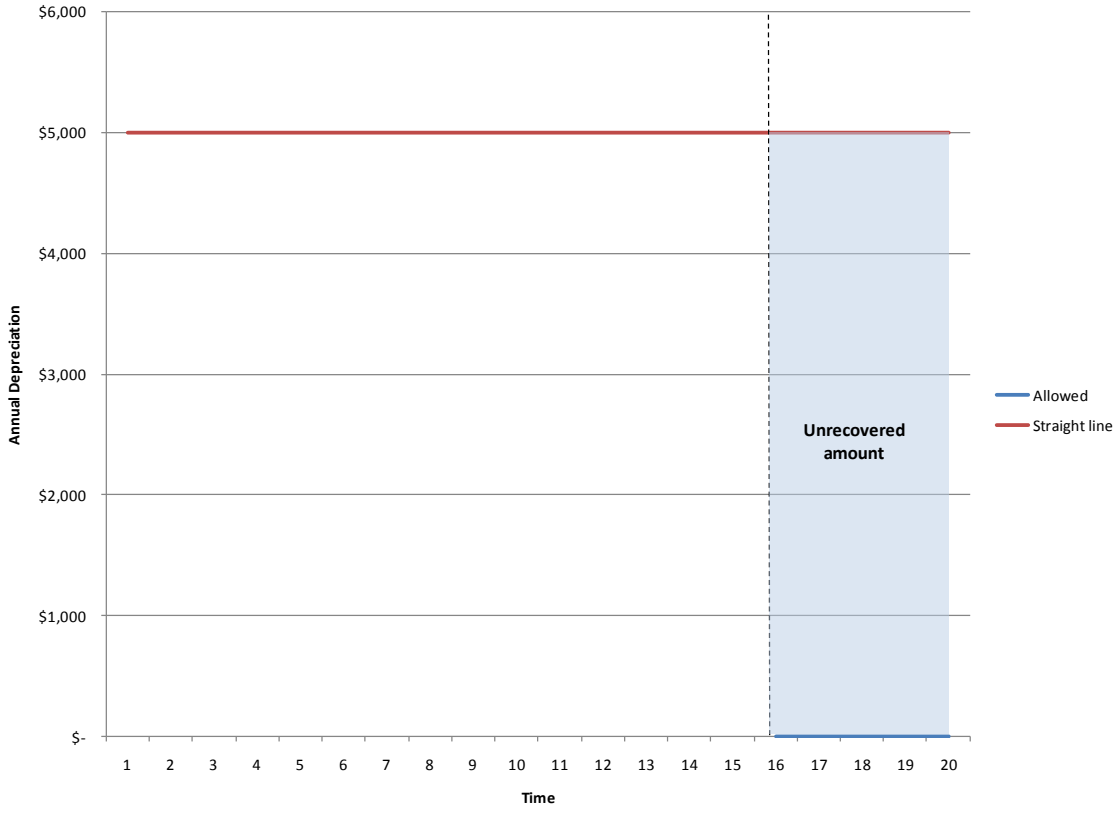


Figure 3: Cost recovery profile for an "old asset" optimised out under TSLRIC+ (reworked Figure 5.12 from the Discussion Paper)



1.1.4.2.3. ASSETS FULLY DEPRECIATED IN THE RAF ACCOUNTS

86. In the Discussion Paper, the Commission states that "under the previous TSLRIC+ regime, Telstra received a return on and of capital on assets that continued in use after they were fully depreciated".[80] There is simply no evidence to support that statement.

87. The context for the Commission's observation that under the previous regime Telstra received a return on assets that were fully depreciated is Telstra's submission that its accounts exclude assets that are still in use (ie still have economic value) as they have been fully written down from an accounting perspective.[81] The relevance of the submission was to demonstrate that the use of the RAF accounts provide an incomplete picture of the remaining economic value of Telstra's actual assets still in use.

88. The Discussion Paper ignores the obvious relevance of the submission and instead seeks to rely on it to support the contention of over-recovery. The essential premise of the Discussion Paper's conclusion is that such assets (having been fully depreciated and therefore, from the Discussion Papers perspective, having been assumed to have been fully recovered) were revalued as new in the Commission's various economic asset valuation methodologies. The premise is simply wrong.

89. The Commission lists three types of assets which it identified as potential assets on which there was over-recovery:

- Tunnel network;
- Copper cable, pit and pipe assets; and
- Other assets including huts, shelters and some software systems.

90. The Commission referred to Telstra's response to the Commission's request for further information, in which Telstra explained under what circumstances assets were fully depreciated from Telstra's asset register, and that it was impractical to audit whether those assets were still in use. The Commission did not ask (and it was not apparent from the approach it was proposing to take), hence in its response, Telstra did not comment on whether those fully depreciated assets were included in the TSLRIC+ asset base in the previous regime, but will do so below.

91. With respect to tunnel assets, the PIE II TSLRIC model that the Commission used to set ULLS prices did not include any value for tunnel assets.[82] Moreover, even if the PIE II model was set to include the cost of tunnels (which it could be), this would have had no impact on ULLS pricing because, even though the default percentage of tunnel costs to include is 25%,[83] any tunneling costs were excluded from the ULLS cost calculation.[84]

92. With respect to copper cable, and pit and pipe assets, these are removed from the asset register when their age is greater than the life attributed to that class of asset. Alternatively, an asset is removed from the register if an end date is applied to the class of asset, and that end date is expired. This means that for these classes of assets, Telstra can identify the latest vintage of assets that have been fully depreciated from the accounts.

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[80] Discussion Paper, p. 58.

[81] Discussion Paper, p. 58.

[82] There is an option in PIE II to build or not to build tunnels in CBD ESAs, which is set by default to NOT build. This option can be found under the Trench Sharing Calculation in the Civil Works and ESA Data module. This covers five ESAs in Sydney and three in Melbourne. The other CBD areas are assumed to have no tunnels.

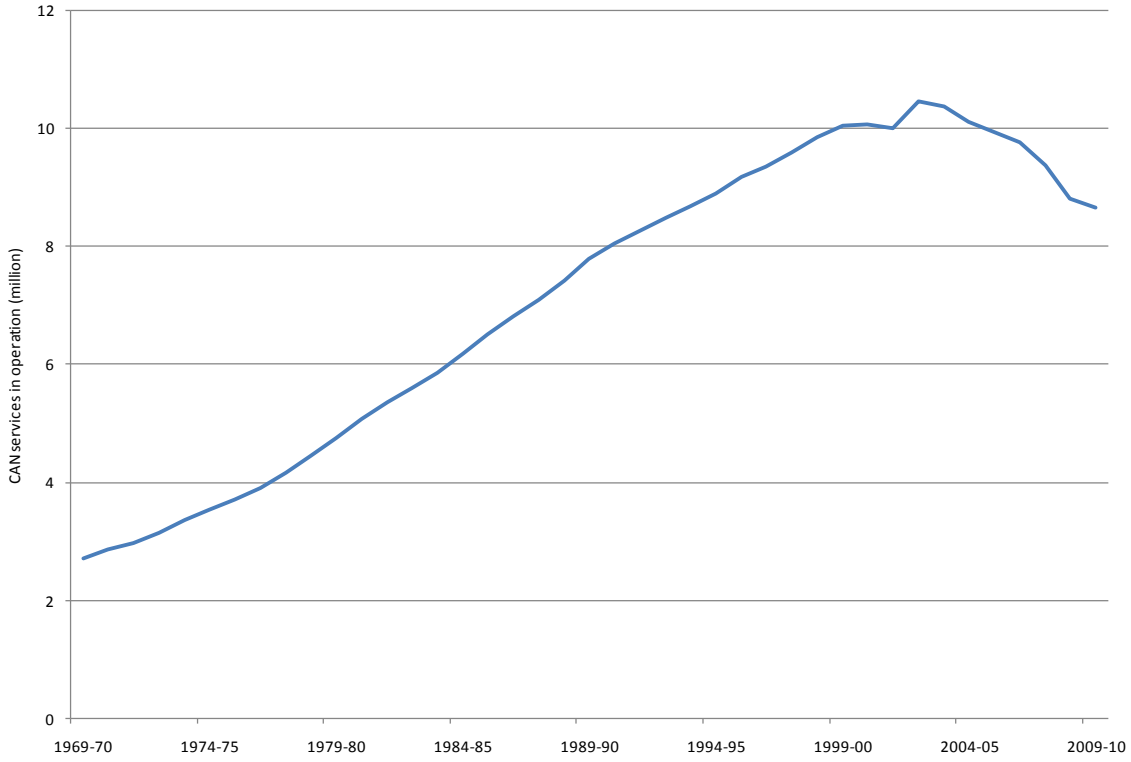
[83] See Miscellaneous Variables in the Costing module for a variable called Tunnel_pct.

[84] During the calculation of the ULL network cost per band, only those elements which are listed in the Access Cost Category table in the ULL Costing module are included in the ULL costing: the tunnel element (Trench_Type_1) is not included in this category table, so the costs are excluded.

93. As explained in Telstra's response to the Commission's request for further information, it is not practical for Telstra to audit whether these assets are still in use. However, this does not mean that the Commission should automatically assume that they have been valued under the old TSLRIC regime. Indeed, it is likely that old copper cable and duct and pipe assets, and particularly those purchased during and prior to 1979/80, were optimised out of the TSLRIC asset base, since TSLRIC measures only the efficient asset base. As noted above, the TEA model optimised out around 35% of duct and pipes and 55% of copper cables.[85]

94. These older assets are the most likely to be optimised out of the TSLRIC+ pricing models, due to the way in which capacity is added to Telstra's actual network over time. Old ducts and pipes and copper cables run out of capacity as neighbourhoods grow and become more densely populated. Telstra's growth in SIOs indicates the extent to which this has happened – Telstra's PSTN SIOs grew gradually from less than 4 million in the mid 1970s, to around 8 million by 1991 and reach a peak at 10.5 million (Figure 4).[86]

Figure 4: Services in operation 1970-2010



Source: Telstra / Telecom / PMG reporting (refer to Schedule A.3 for details)

95. As demand grew, rather than digging up existing infrastructure and replacing it with bigger pits, pipes and cables, it has been most cost effective for Telstra to add additional pits, pipes, and copper cables either next to the existing infrastructure or on the other side of the road. In a TSLRIC context, those older assets that have had additional assets purchased to augment capacity would be optimised out of the asset base. Instead of costing an old and a new cable which lie side-by-side, a TSLRIC model would simply assume just one cable running down one side of the road.

[85] Telstra, *Measure of TEA Model Efficiency: ULLS Band 2 – version 2*, March 2009, p. 6.

[86] Telstra/Telecom/PMG reporting – refer to Schedule A.3 for details.

96. For these reasons, it would be extremely unlikely that cable, pit and pipe assets that have been fully depreciated from Telstra's asset register would have been included in the Commission's TSLRIC asset base. There is certainly no evidence that they were included (which is an essential precondition for the conclusion in the Discussion Paper).

97. With respect to other assets such as huts and shelters, it does not appear that these assets are explicitly included in the PIE II costing which the Commission used to set ULLS prices, although they may be included in the land and buildings markup factor. In any event, these assets are likely to represent a very small fraction of the asset base costed under TSLRIC+ to the extent that they were costed at all. Around 97% of the TSLRIC+ asset base was accounted for by cable, pit and pipes assets.[87]

1.1.5. THE COMMISSION FAILED TO PROPERLY CONSIDER INDEXED HISTORIC COST VALUES PROPOSED BY TELSTRA

Key points:

The Commission failed to properly consider indexed historic cost values proposed by Telstra as the appropriate historic cost measure.

The justification for relying on unindexed values is that Telstra has previously been compensated for inflation through nominal returns on capital.

The Commission's assumptions about past treatment of inflation are incorrect.

In the context of transitioning from a TSLRIC+ pricing framework to a building block framework based on historic cost, there will be no "double counting" of inflation if indexed values are used.

98. In the Discussion Paper, the Commission maintains its view that unindexed historic costs is an appropriate starting point (floor) for valuation and rejects Telstra's submission that historic values must at least be indexed. Referring to the opinion of Professor Yarrow, the Commission suggests that such indexation would amount to double counting, as compensation for inflation would have been previously provided both in the annual capital charge and in the change in the value of the asset base.[88]

99. In rejecting Telstra's submission in respect of indexation, the Commission has misinterpreted the opinion of Professor Yarrow in a number of ways:

(a) The Commission has selectively quoted from Professor Yarrow while ignoring his overall recommendation that the valuation in a BBM be consistent with previous valuations, to avoid "economic mugging";[89]

(b) The Commission ignores the caveat in the very next paragraph of Professor Yarrow's opinion that simply looking at whether a nominal weighted average cost of capital (**WACC**) has been applied in the past is to ignore the treatment of depreciation under the previous regime (which in this case relied on a positively tilted annuity with backloading of depreciation);[90] and

[87] These assets are denoted in the PIE II model as Distribution Cable, Distribution Conduit, Main Cable and Main Conduit and make up 96.8% of the total capital costs calculated by the PIE II model.

[88] Discussion Paper, p. 54.

[89] Yarrow Report, p. 9.

[90] Yarrow Report, p. 13.

(c) The Commission ignores Professor Yarrow's recommendation that in the current circumstances, if the regulatory accounts are to be used, these should be properly adjusted for inflation.[91]

100. Professor Yarrow's concern is plainly with a situation where an Access Provider (1) has been compensated on the basis of DAC for a period of time with (2) the capital charge being determined through the application to the DAC RAB of a nominal WACC and (3) presumably together with some form of accounting depreciation. However, this is clearly not the case here.

101. It is accepted that depending on the tax arrangements, a capital charge could compensate for inflation, in which event revaluation of the asset base would amount to double counting. However, that comparison has no bearing on Telstra's situation. Telstra has not been compensated on the basis of a nominal WACC applied to a nominal, historical cost, asset base accompanied by accounting depreciation. Rather, Telstra's access charges have been set on the basis of TSLRIC using a tilted annuity. There is no sense in which the resulting capital charges have compensated Telstra for the impact of inflation on the value of its assets measured at historical cost.

102. Under the TSLRIC+ regime Telstra did not receive additional compensation for inflation. Rather, the effect of inflation under TSLRIC+ was to exaggerate the extent to which cost recovery was deferred by the tilted annuity. The Commission notes this in an early decision:[92]

> *Inflation enters into the tilted annuity for the purposes of calculating nominal annual capital costs. The effect of higher inflation is to cause the annuity to become more backward tilted and thus year 1 capital costs are lower than would be the case with a lower inflation rate.*

103. To say this is not to deny that, as the Commission suggests, it is possible to construct hypothetical scenarios in which a hypothetical Access Provider receives more (or less) compensation in aggregate under a TSLRIC standard applied for a period than it would have received had it been compensated on the basis of historical cost accounting (**HCA**).[93] However, such hypothetical examples (which presumably have been made assuming that the regulator shifting from TSLRIC to HCA, or the possibility of such a shift, does not in itself affect the observed time path of investment) are of no clear relevance to Telstra's situation.

104. The Commission's reasoning on this point highlights the risks associated with changing the basis for asset valuation. The Commission's reasoning appears to assume that some form of HCA had been used previously, when this is clearly not the case. Rather, the Commission has now decided to transition to an HCA system after more than a decade of using forward-looking costing with a positively tilted annuity. In the context of such a significant change in valuation methodology, one cannot simply assume that the Access Provider has been properly compensated for inflation, by reference to the use of a nominal WACC in the previous accounting system which treated capital costs very differently.

105. As is shown below, transitioning from one accounting system to another will not result in over-recovery of inflation costs if the asset value is treated consistently. For instance, inflation costs would not be over-recovered if a FLSM were to replace a Replacement Cost/Tilted Annuity accounting system and the opening asset value for the FLSM was equal to the closing asset value prior to the transition. This is true despite the use of a nominal WACC in the Replacement Cost/Titled Annuity accounting system.

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[91] Yarrow Report, p. 13.

[92] ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p. 100.

[93] Discussion Paper, p. 58.

106. However, if in the transition to the FLSM the opening asset value is set equal to indexed or unindexed historic cost, inflation costs will be under-recovered. The extent of under-recovery will be worse if unindexed historic costs are used. This is because (as noted by the Commission in previous decisions) the Replacement Cost/Tilted Annuity accounting system defers the recovery of the cost of inflation (and capital costs generally).

107. Accordingly, in order to minimise the extent to which capital costs are to be stranded in the transition to HCA, the Commission must at least index the value of Telstra's fixed line assets recorded in the historic cost accounts. This is however a second best alternative to a DORC valuation based on the closing value of Telstra's fixed line assets at the conclusion of the TSLRIC+ regime.

108. The remainder of this section first identifies relevant account systems and identifies how they compensate for the cost of inflation. It then discusses the transition between different accounting systems.

1.1.5.1. ACCOUNTING SYSTEMS COMPENSATE FOR THE COST OF INFLATION

109. Properly constructed, accounting systems will account for the cost of inflation in different ways, but will not result in double counting of inflation costs, if they are applied over the lives of the relevant assets. Generally, there are three ways inflation costs can be included in an accounting system:

- through income, by applying a nominal WACC;
- through capital, by indexing asset values to capitalise the costs of inflation; and
- again through income, by subtracting the cost of inflation from depreciation.

110. Different accounting systems use different combinations of the above to account for inflation costs.

(a) First, under a HCA system a nominal WACC is applied to the unindexed value of assets. The cost of inflation is counted once as income and is not capitalised.

(b) Second, under a Replacement Cost/Tilted Annuity system, the cost of inflation enters into cost recovery by three means: a nominal WACC is applied so the cost of inflation is counted once as income; but the cost of inflation is subtracted off income again as it is subtracted from depreciation; and the cost of inflation is capitalised as the asset value is indexed.

(c) Third, under a Real Post-Tax Revenue Model (**PTRM**), all income (except corporate tax related income) and capital is first calculated in real terms, but these values are then multiplied by a compound inflation rate to account for the cost of inflation. This means that the cost of inflation is capitalised by indexing the value of assets.

111. The Commission's FLSM is a form of PTRM. For assets that are added into the asset base after the start date of the model (1 July 2009), the FLSM counts the cost of inflation as PTRMs do generally as set out above. However, the Commission enters assets that existed prior to the start date of the model into the FLSM as unindexed values, and then begins indexing them after the start date of the model. If existing assets are valued at indexed historic cost in the Commission's FLSM, instead of unindexed values, then the FLSM would operate in the same way as PTRMs more generally. All income and capital would initially be valued in real terms in the model (at the start date of the model). These values would then be multiplied by a compound inflation rate to account for the cost of inflation.

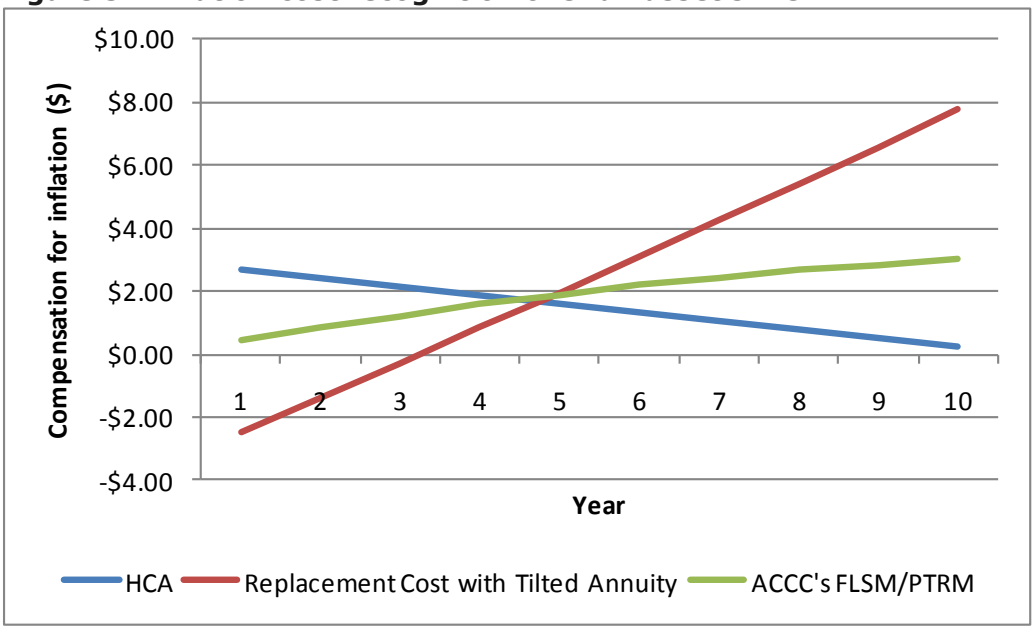
112. How these approaches account for the cost of inflation are illustrated in Table 1, assuming they are applied throughout the asset's lives.

Table 1: **Inflation cost recognition under different accounting systems**

Accounting System	Applying a nominal WACC	Indexing asset values to capitalise the costs of inflation	Subtracting the cost of inflation from depreciation
HCA	Inflation cost added		
Replacement Cost/Tilted Annuity	Inflation cost added	Inflation cost added	Inflation cost subtracted
PTRM/FLSM		Inflation cost added	

113. Schedule A.4 illustrates the cost recovery path for a $100 asset under each of these accounting systems: Table 1.1 for HCA; Table 1.2 for Replacement Cost/Tilted Annuity; and Table 1.3 for the FLSM accounting system. These tables show that the present value of the inflation costs recognised under each accounting system is the same - $10.34. However, the paths of inflation cost recovery are different as illustrated in Figure 5 below.

Figure 5: Inflation cost recognition over an asset's life



1.1.5.2. TRANSITIONING BETWEEN ACCOUNTING SYSTEMS

114. The Commission's statement above is directed toward the use of a nominal WACC in the prior accounting system, and the implications of that for how assets are valued in the transition to an accounting system based on the FLSM.

115. Inflation costs would not be double counted if it is assumed that, prior to the switch to the FLSM, a nominal WACC was used in an indexed historic cost accounting system, and the closing asset value from that system was used as the opening asset value in the transition to the FLSM. This is illustrated in the example in Table 2.1 in Schedule A.4, which sets out the cost recovery path for a $100 asset, using the same inputs that were used in Schedule A.4.

Appendix 2 differs to Appendix 1 in that it is assumed that, at the beginning of year five, the accounting system transitions from indexed historic cost to the FLSM with consistent asset values.

116. However, it would be more accurate to assume that, prior to the transition to the FLSM, a nominal WACC was used in a Replacement Cost / Tilted Annuity accounting system. In this case, inflation costs would not be double counted if the closing asset value from the Replacement Cost/Tilted Annuity accounting system was used as the opening asset value in the transition to the FLSM. This is illustrated in Table 2.2 in Schedule A.4. In both these cases, even though a nominal WACC was used prior to the transition to the FLSM, the present value of recognised inflation costs is $10.34 – the same as if the individual accounting systems had been applied over the entire assets' lives.

117. Finally, it is shown that inflation costs would be under-recovered if, prior to the transition, a nominal WACC was applied in a Replacement Cost/Tilted Annuity accounting system and, after the transition, the FLSM is used with (a) indexed historic cost, and (b) unindexed historic cost. The former is illustrated in Table 3.1 and the later in Table 3.2, both in Schedule A.4. The extent of under-recovery is greater if unindexed historic cost is used.

1.1.5.3. CONCLUSION

118. For the reasons set out above, use of an indexed historic cost valuation would not amount to "double counting" of inflation. It follows that the unindexed DAC used by the Commission, updated only by applying an inflation adjustment to land, materially understates the value of the asset base, aggravating the loss to Telstra's shareholders from the failure to honour the capital charges deferred under the Commission's prior TSLRIC approach.

119. In the current context, indexation is necessary to ensure recovery of Telstra's historic investment costs in real terms. This is particularly so given that the FLSM purports to calculate prices in real terms, based on a valuation of the asset base as at 30 June 2009.[94] What the Commission fails to recognise is that the RAB values it derives from the RAF accounts and uses in FLSM are not in June 2009 dollars and need to be indexed accordingly. Telstra's DHIC calculation (unlike the Commission's) does express historic costs in real terms.

1.1.6. THERE IS NO VALIDITY TO THE COMMISSION'S APPROACH OF WORKING BACKWARDS FROM THE BAND 2 ULLS PRICE

Key points:

In selecting a value for Telstra's CAN and IEN assets above its DAC floor, the Commission adopts a novel and idiosyncratic approach to valuation which takes into account just one factor – the price set in its 2008/09 pricing principles decision for the ULLS in Band 2.

The Commission does not have regard to the *anticipated path* of prices established in recent pricing decisions.

As a result, the Commission's decision on the initial asset base does not achieve the objective of providing price stability.

[94] Discussion Paper, p 30; FLSM, sheet "2. RAB", cell E10.

1.1.6.1. THE COMMISSION HAS SOUGHT TO ESTABLISH A SINGLE PRICE, NOT A REASONABLE VALUATION

120. The Commission establishes a value above its DAC floor based on one consideration alone – maintaining a price of $16 for ULLS in Band 2, which is then applied across Bands 1 to 3.[95]

121. Telstra submits that the Commission has set itself the wrong objective in determining a value for Telstra's fixed line assets in this way. The Commission has not given sufficient consideration to the appropriate value to be ascribed to Telstra's asset base and has instead simply set out to maintain the prevailing ULLS price in Band 2.

122. It is not clear how setting the initial RAB value by reference to the price for a single service can provide for a reasonable valuation of Telstra's fixed line assets, particularly in circumstances where that price was set some two years ago as part of an upward price path (and has simply been rolled over in the meantime as the Commission has considered the transition to a building block methodology). As Telstra has previously noted, the remaining economic value of its fixed line assets (as established through previous pricing decisions) is in fact significantly higher than the value proposed by the Commission.

123. The Commission's approach to determining the initial RAB value appears to gives no meaningful consideration to what the value of Telstra's asset base might actually be, other than to note that it is likely to be somewhere above its DAC floor.

124. Rather, the Commission appears to place significant weight on the fact that DSLAM investments have been made by Access Seekers in Band 2 exchanges based on a $16 ULLS price. In this regard, Telstra notes that the $16 price for ULLS in Band 2 was in fact established after many DSLAM investments were made. This price was established in a series of arbitration determinations published in April 2010, as part of an upward price path reflecting the Commission's positively tilted annuity.[96]

1.1.6.2. INSUFFICIENT CONSIDERATION HAS BEEN GIVEN TO PRICE PATHS AND VALUATIONS ESTABLISHED IN PREVIOUS DECISIONS

125. The previous pricing decisions on which the Commission relies established a path for prices, not just a single price.

126. The previous pricing decisions which form the basis for the Commission's valuation were based on TSLRIC+ cost modeling with positively tilted annuities. The effect of the tilted annuity was to establish an upward path for prices and cost recovery over time, in line with the projected upward trends in the replacement costs of key assets such as ducts and cables. The effect of the tilted annuity on pricing can be seen clearly in recent pricing decisions for the ULLS (Table 2).[97] The prices in Table 2 (except those for 2009/10 which were simply rolled over from the previous year) were calculated from Telstra's PIE II cost model (a TSLRIC+ model) using the Commission's preferred inputs, including a tilted annuity. The effect of the tilted annuity is to establish an upward path for prices and recovery of capital costs.

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[95] The Commission has indicated in discussions with Telstra that it has used the "Goalseek" function in Excel to derive its final asset value. The "Goalseek" function determines the value for ducts and pipes that is needed to achieve a $16 ULLS price. However, Telstra has been unable to replicate this calculation.

[96] ACCC, *Access dispute between Agile Pty Ltd (Access Seeker) and Telstra (Access Provider) – Unconditioned Local Loop Service (ULLS): final determination under section 152CM of the Trade Practices Act 1974*, April 2010.

[97] ACCC, Final determination in the ULLS access dispute notified by Optus on 18 November 2005, dated 21 April 2008; ACCC Final determination in the ULLS access dispute notified by Chime on 26 June 2008, dated 7 April 2010.

Table 2: ULLS pricing established in recent Commission arbitration determinations

	2005-06	2006-07	2007-08	2008-09	2009-10*
Band 1	$5.60	$6.00	$6.20	$6.60	$6.60
Band 2	$12.30	$13.70	$14.30	$16.00	$16.00
Band 3	$25.00	$27.30	$28.50	$31.30	$31.30

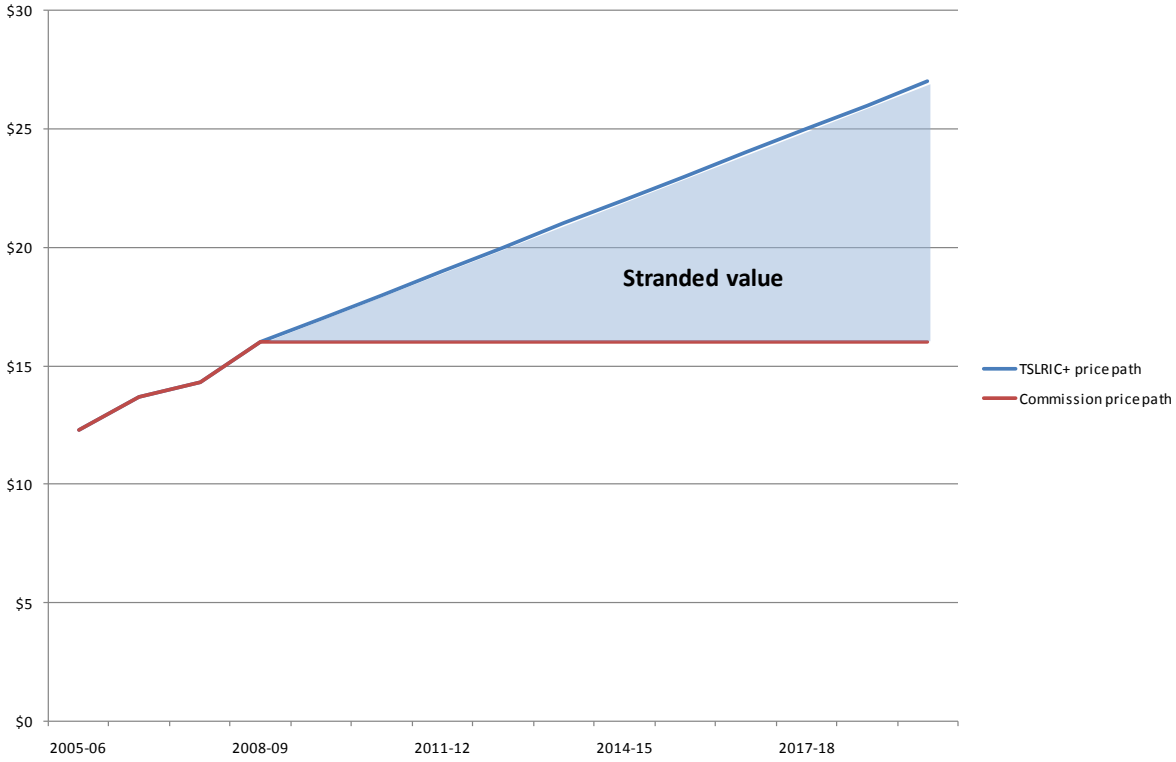
*Note: prices for 2009-10 were rolled over from the previous year

127. In the recent Tribunal proceedings in relation to Telstra's 2008 ULLS Undertaking, all parties recognised that the positively tilted annuity applied by the Commission implied an upward path for prices to allow for future recovery of deferred depreciation. The Tribunal notes in its reasons for its decision:[98]

> *In an environment of increasing price trends a tilted annuity will have the effect of deferring cost recovery, though the Tribunal is unable on the evidence presented to be entirely comfortable as to the extent of those increases.*
>
> *Even so, a fundamental issue (particularly for Telstra) is whether the environment it would face in the future would make this recovery possible.*

128. By choosing to maintain the 2008/09 price for ULLS in Band 2 rather than establishing a RAB value consistent with this upward price trend, the Commission is ensuring that Telstra will not recover the deferred costs referred to by the Tribunal. In effect, the Commission is stranding a significant portion of the remaining value of the fixed line network.

Figure 6: Stranding of value



[98] *Application by Telstra Corporation Limited* [2010] ACompT 1 (10 May 2010), at paragraph 319-320.

129. In this context, it is not the case that locking in the current price will protect the legitimate business interests of Telstra. Rather, Telstra submits that if expectations are relevant, both its and Access Seekers' price expectations have been determined by the tilted annuity recovery profile, so that it is that profile, rather than charges at a particular point in time (in this case 2008/09) that should properly be taken into account in determining the present value of future charges.

130. Accordingly, to be truly consistent with previous pricing decisions and provide for regulatory consistency and certainty, the Commission should set the initial RAB by reference to the path of prices established in previous decisions. While the price paths set by the Commission are based on the PIE II model, rather than the more recent models used by Telstra to calculate DORC, having regard to these price paths would be consistent with the approach that has been advocated by Telstra in this submission (refer to section 1.1.2) and previously.

1.1.6.3. IMPACT ON PRICING FOR OTHER SERVICES

131. Whilst maintaining the prevailing ULLS price in Band 2, the Commission proposes a significant reduction in prices from previous levels for a number of services, particularly WLR. There is no apparent reason why this should be the case and the Commission does not appear to turn its mind to the question of why this is happening in the transition to building blocks. As Professor Yarrow notes, there is no inherent reason why a change in regulatory approach should lead to significant adjustments in prices.[99]

132. Pricing for services other than the ULLS are a function of the initial RAB which is determined by reference to the 2008-09 Band 2 ULLS price. To the extent that the Commission's approach results in a significant reduction in prices for these other services, this should alert the Commission to the possibility that their approach is leading to a significant devaluation of Telstra's fixed line assets.

133. The closest the Commission comes to justifying the devaluation and significant reduction in WLR and LCS prices is in the statement of reasons accompanying the Interim Access Determinations (**IADs**), where it states:[100]

> *Falling investment in some of the equipment used to provide the fixed line services (for example, switching equipment) has reduced the costs of providing WLR and LCS. The costs of providing those two services have also been reduced by removing the monopoly profits built into the previous RMRC-based indicative prices.*

134. There is no support for the assertion that "monopoly profits" have been built into WLR and LCS prices in the past, nor does there appear to be any analysis of whether the cost of providing these services has in fact declined.

135. As noted in Telstra's submission on the 2010 Draft Report, previous Commission analysis suggests that RMRC prices for WLR were in fact below cost, rather than above cost as the Commission claims.[101] In light of this previous analysis, it is extraordinary for the Commission to now claim that Telstra has historically received monopoly profits on regulated WLR.

136. In respect of the Commission's claim that costs have declined, it is not clear what costs the Commission is referring to, or what evidence it has to support this claim. To the extent that the Commission is referring to capital costs, any decline in asset replacement costs should be irrelevant in the context of the "actual cost" model relied on by the Commission.

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[99] Yarrow Report, p. 3.

[100] IADs statement of reasons, p. 13.

[101] Telstra's submission noted that the most recent TSLRIC+ estimates for WLR (from the Commission's Analysys model) indicated that the nationally averaged TSLRIC+ was well above the prevailing RMRC price (Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p 17 and Schedule 9).

1.1.7. DEVALUATION MATERIALLY AFFECTS TELSTRA'S ABILITY TO RECOVER ITS COSTS

137. The Commission's proposal would result in a significant devaluation of Telstra's fixed line assets. As noted above (section 1.1.3), the value of Telstra's fixed line investments established in recent decisions is around $31 billion. Therefore the Commission's decision to value the initial RAB at $17.75 billion would result in a devaluation of around $13 billion.

138. This decision also has a material impact on the unit costs that may be recovered by Telstra from the provision of fixed line services. As shown in Table 3, the FLSM with an initial RAB value of $17.75 billion calculates a unit cost for the ULLS of $20.06 (per SIO per month), which is around 35% lower than the unit costs implied in the pre-IAD prices.

139. On the other hand, if either the DORC or indexed historic cost valuations proposed by Telstra are used in the FLSM, unit costs for the ULLS are broadly in line with what was in place prior to the IAD. This is somewhat unsurprising given that Telstra's valuations are designed to be consistent with the valuations implied in previous pricing decisions.

Table 3: Materiality of RAB devaluation (impact on unit costs)[102]

	ULLS	WLR	LCS	WLR/LCS bundle	PSTN OTA	LSS
Pre-IAD	$27.18	$25.57	17.3c	$52.34	1.0c	$2.50
FLSM default	$20.06	$22.47	8.7c	$35.84	1.0c	$1.80
DORC value	$26.85	$30.94	9.7c	$45.85	1.1c	$1.80
DIHC value	$28.04	$30.51	10.7c	$47.06	1.2c	$1.80

1.1.8. THE VALUATION OF TELSTRA'S FIXED LINE NETWORK INVESTMENT DOES NOT REFLECT A PROPER CONSIDERATION OF THE EVIDENCE OR RELEVANT CONSIDERATIONS

140. The Commission has in substance determined the initial RAB value by:

(a) back solving an asset value based on the application of only one price, the ULLS Band 2 price set by the Commission in its 2008/2009 pricing principles review,[103] applied across Bands 1 to 3; and

(b) check testing the resulting asset value against the residual regulatory accounting values in Telstra's regulatory accounts for its CAN and IEN assets (after indexing the nominal accounting values for land to derive a real land value).

141. The valuation approach is arbitrary in that it is based on the selection of one price, from a set of relevant regulatory prices, determined at one point in time to determine the residual value of Telstra's fixed line network investments. There is no rational basis to determine the value by reference to one price, rather than by reference to the full set of regulatory prices. Furthermore, there is no rational basis to determine the value by reference to a price (or even a set of prices) determined under a prior regulatory determination as at one point in time, without considering the anticipated path of prices under that regulatory determination and the explicit or implicit asset valuation.

[102] Refer to Schedule A.9 for detailed workings.

[103] ACCC, *Unconditioned Local Loop Service: Pricing Principles and Indicative Prices*, June 2008, p. 22. The ULLS prices established for 2008-09 were subsequently rolled over for 2009-10.

142. In its Discussion Paper, the Commission notes:[104]

> *The ACCC considers that, in determining an initial RAB value for the CAN and Core assets, it is important to protect the legitimate business interests of both access seekers and Telstra. This consideration has led the ACCC to conclude that a clear justification is required for any significant change in existing prices.*

143. However, the only justification given for the approach actually adopted of using the Band 2 ULLS prices to determine the value of Telstra's assets is investments undertaken by Access Seekers in Band 2 exchanges are said to have been made on the basis of the $16 Band 2 price.[105] Not only is there no evidence to support the conclusion that the $16 Band 2 price was the driver of Access Seeker investment decisions[106], to allow only this consideration to be the principal determinant of the value of Telstra's investments is manifestly unreasonable.

144. If there is any rationality to this approach, it surely rests on the implicit basis that without clear justification it should reasonably be expected that there would be principled consistency and predictability in the valuation of a regulatory asset from one determination to another. Such a principle is essential for investment incentives and essential to a proper recognition of an Access Provider's legitimate business interests.

145. However, to select just one price at one point in time to give effect to regulatory consistency and predictability over time is simply arbitrary. Indeed the approach does not even give practical application to the Commission's own, incomplete, principle that "a clear justification is required for any significant change in existing prices".

146. The valuation approach is also unorthodox and idiosyncratic. It is without any apparent support in regulatory precedent and runs directly contrary to orthodox and good regulatory practice as reflected in the opinions of Professors Yarrow and Sappington.

147. In the words of Professor Yarrow:[107]

> *As a matter of principle, a change in the approach to setting regulated access prices should not by and of itself have any material effect on economic outcomes. If it does, the likelihood is that what is happening is an economic 'mugging' of one economic interest by another (ie a form of opportunism); and that would arguably be an ill-starred opening to a new, and otherwise promising, regulatory chapter.*

148. Professor Sappington in reviewing the approach set out in the Commission's Discussion Paper, observed:[108]

> *To promote the LTIE by consistently respecting the legitimate business interests of access providers, regulators should enhance the predictability of their policies by specifying clearly the principles that will guide their decisions and then faithfully following these principles when making decisions. Regulatory predictability endows investors with a clear understanding of the regulatory policy that will be implemented as industry conditions evolve, and thereby limits "regulatory surprises." As the likelihood of regulatory surprises declines, investors become more willing to supply capital to the regulated industry on reasonable terms and conditions, thereby promoting the LTIE.*

149. By then checking the valuation against a DAC floor, it is apparent that the Commission incorrectly considered it was a sufficient consideration of Telstra's legitimate business interests that it set a price above a level that was said to allow the recovery of historic investment costs (and a commercial return).

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[104] Discussion Paper, p. 47.

[105] Discussion Paper, p. 47.

[106] In this regard, Telstra notes that the $16 price for ULLS in Band 2 was in fact established after many DSLAM investments were made. This price was established in a series of arbitration determinations published in April 2010, as part of an upward price path reflecting the Commission's positively tilted annuity.

[107] Yarrow Report, p. 13.

[108] Sappington Report (Schedule A.1), p. 4.

150. The Commission then gave no further consideration to Telstra's legitimate business interests beyond this point. Given Telstra's clear and legitimate business interest in recovering the depreciated value of its investment (not some past depreciated accounting cost), the Commission has clearly failed to give full and meaningful consideration to those interests.

151. Further, the proposition that historic accounting costs and accounting depreciation (including prior to the implementation of the access regime) are relevant in the context of the legislative criteria guiding the Commission's decision has no apparent rational basis. Consistent and repeated regulatory statements have rejected the use of historic accounting valuations as a suitable candidate for a starting RAB, let alone a RAB in a transition from a forward-looking optimised replacement cost methodology. Further, the proposition gives no consideration to the interests of the investors in Telstra who have invested under a Government privatisation program in the context of the Commission's forward-looking replacement cost methodology for valuing its assets.

152. In checking against the DAC floor, the Commission assumes that the residual regulatory accounting values in Telstra's regulatory accounts for its CAN and IEN assets (after indexing the nominal accounting values for land to derive a real land value) reflect the unrecovered historic costs of the investment in those assets; where there is simply no evidence to support the conclusion. The conditions necessary for that assumption to hold true do not exist. In particular:

    (a) residual accounting values do not reflect economic depreciation recovered through prices;[109]

    (b) regulated prices have not been set in the past by reference to nominal accounting depreciation;[110]

    (c) regulated prices are unlikely to have allowed cost recovery of nominal accounting depreciation (as discussed in section 2.1.4 above).

153. In relation to this last point at 152(c) above, in response to evidence from Telstra, the Commission itself accepts that the TSLRIC+ tilted annuity methodology has the consequence that under a transition to a building blocks methodology using the RAF accounting values Telstra will not recover its investment costs incurred since implementation of the TSLRIC+ regime.

154. In order to support its continued use of the RAF accounting values, the Commission has then erroneously, and without any rational basis or supporting evidence, conjectured that this under-recovery is likely to be offset by over-recovery on older assets. Without this conclusion, the Commission could simply not have used the unindexed residual accounting values as its check floor valuation.

155. In adopting this approach, it is apparent that the Commission has given no meaningful regard to its past regulatory pricing principles and the residual valuation of Telstra's assets under past decisions. The Commission has also failed to give any regard to the interests of the investors in Telstra who have invested in the context of those principles and decisions.

156. The Commission has rejected, without meaningful consideration both an orthodox candidate: DORC valuation, and indexed historic cost valuation, both of which valuations are consistent with its prior regulatory decisions.[111]

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[109] Refer to section 2.1.5.1 above and the expert report of Mr Bruce Porter (Bruce Porter, *Expert Advice Re: Use of Written Down Accounting Value of Fixed Network Assets*, 21 October 2010 (Schedule 2 to Telstra's submission on the Draft Report)).

[110] A detailed history of price regulation is set out in Schedule A.3.

[111] As noted in section 2.1.7 above, Telstra's DORC and indexed historic cost valuations provide for unit cost estimates that are consistent with those prevailing prior to the IAD, whereas the Commission's valuation leads to a significant reduction in unit costs that Telstra can recover.

157. While the Discussion Paper appears to recognise that the choice of valuation method could, "by creating a risk of regulatory opportunism, deter future investments in sunk assets by regulated businesses",[112] the Commission has adopted a valuation which substantially, and apparently irreversibly, reduces the value of Telstra's investment in the CAN and IEN, without any apparent consideration of the justification for such a result and without any apparent regard to the manifestation of these risks in its very choice of asset valuation methodology.

158. In adopting this approach, and reaching this conclusion, it is apparent that the Commission has failed to give meaningful consideration to relevant statutory considerations, including:

    (a) the impact on the incentives for investment in infrastructure if simply by reason of a change in regulatory methodology there is a substantial devaluation in the value ascribed to an access provider's investment;

    (b) Telstra's legitimate business interests in recovering through prices for declared services the value of its investments, including the value reflected in past regulatory decisions; and

    (c) Telstra's legitimate business interest in not being subject to ad hoc and arbitrary changes in the value of its investment, simply by reason of a change in the regulatory methodology for setting prices.

159. The Commission should, in making its Final Access Determinations (**FADs**), correct these manifest deficiencies by having proper regard to the value of Telstra's investment in the CAN and IEN as reflected in its past regulatory decisions.

[112] Discussion Paper, p. 54.

1.2. The Commission's FLSM incorrectly forces unit costs to remain constant

Key points:

In the FLSM, the Commission assumes that demand will remain constant over time. In relation to:

- ULLS and WLR services – it is assumed that 2009/2010 total services in operation is held constant over time; and
- PSTN OTA services – it is assumed that 2002/2003 "peak" total call minutes is held constant over time.

The effect of the Commission's assumption is that unit costs remain constant over time. This, in turn, has the effect of allocating costs to services that do not exist such that Telstra:

- cannot recover the value of its investments as valued by the Commission; and
- will not recover its actual forward-looking operating and capital expenditure costs.

The Commission has sought to justify its approach on the basis of a hotel analogy. This analogy is irrelevant and does not, in fact, support the Commission's approach to cost allocation.

Critically, the Commission's approach:

- is not consistent with the Commission's previous approach or the approach taken by other regulators; and
- cannot be supported by reference to the legislative criteria.

The Commission has also, incorrectly, suggested Telstra is compensated for the risks associated with declining demand through the risk premium in the WACC.

The cost allocation factors must be adjusted for changes in demand over time. Such adjustments would be consistent with the legislative criteria.

1.2.1. OVERVIEW

160. In the Discussion Paper, the Commission states that it does not accept that the cost allocation factors for the declared fixed line services should be adjusted to reflect declining total demand for fixed line services, since this would mean increasing unit costs as total demand declines.[113]

161. The impact of not taking into account demand changes over time can be seen in the FLSM. Effectively, the Commission:

    (a) calculates a revenue requirement which is intended to represent the minimum amount that Telstra must earn from retail and wholesale fixed line services to recover its accounting costs; and

[113] Discussion Paper, p. 127.

(b) allocates this revenue requirement to the wholesale services based on its cost allocation factors. The cost allocation factors for several asset categories (including ducts and pipes, copper cables, local switching, trunk switching and other switching, which make up almost 50% of the FLSM's RAB), are calculated on the basis that demand is constant over time, at a historical level of demand. This means that the unit costs are effectively constant over time.

162. The effect of this assumption is that a substantial proportion of Telstra's revenue requirement is allocated to services that are no longer purchased. KPMG reviewed the Commission's cost allocation methodology in the FLSM and calculated the amount of the revenue requirement that was allocated to services that no longer exist. KPMG found that:

- for ULLS and WLR services, Telstra will not recover $140 million of the revenue required to recover its costs over three years (to 2012/2013); and
- for PSTN OTA, Telstra will not recover $1.98 billion of the revenue required to recover its costs over seven years (to 2015/2016).

163. In total, KPMG found that over $2 billion of Telstra's revenue requirement is unrecoverable (refer to Schedule A.5).

164. The Commission's cost allocation methodology prevents Telstra from recovering its "actual costs" (assuming that the pre-allocation initial RAB value that the Commission derived "would allow Telstra to recoup its actual investment costs and achieve a commercial return on those investments"[114]). To be clear, even if the Commission's initial RAB valuation allowed Telstra to recover its actual investment costs and a commercial return on those investments (which it does not as explained in detail in section 1.1 above), the Commission's cost allocation method means that Telstra cannot recover either its investment costs as valued by the Commission or its forward-looking operating and capital expenditure costs.

165. Inherent in the Commission's approach are several inconsistencies. The most significant is between the Commission's approach to valuing the initial RAB and the Commission's approach to cost allocation. The former is based on a backward looking, unindexed historical cost valuation which effectively reflects today's accounting costs as recorded in the RAF. The latter is based on a backward looking, optimised view of "peak" demand for PSTN traffic and a level of demand for SIOs for the base year of the FLSM.

166. The basis for the Commission's assumption that demand remains constant over time is that it does not consider it "appropriate to compensate Telstra for a loss of market share".[115]

167. It is incorrect to say that taking account of demand changes involves "compensating Telstra for a loss of market share".[116] Taking account of actual demand and real relative demand changes is fundamental to ensuring that the cost of providing access services is recovered from Access Seekers by Telstra.

168. It is also incorrect to say that "[m]uch of the fall in total demand for fixed line services reflects reduced demand for Telstra's retail services".[117] There are a range of reasons why total demand for fixed line services is declining – some of which are identified by the Commission in its Discussion Paper.[118] The Commission does not seek to distinguish reduced demand because of the competitive activity of other parties, from shifts in retail customers

[114] Discussion Paper, p. 54.

[115] Discussion Paper, p. 127.

[116] Discussion Paper, p. 127.

[117] Discussion Paper, p. 127.

[118] The Commission identifies fixed to mobile substitution, substitution away from PSTN OTA, LCS and WLR to ULLS and reduced demand for Telstra's retail services. See Discussion Paper, p. 127.

away from use of Telstra's fixed line network for voice calls due to long run trends in demand, including switching to the use of a mobile network for voice calls, through VoIP on a Telstra fixed line, and also the general decline in the use of second lines. Nor does the Commission seek to distinguish what costs would have been avoided had historical demand been lower, as one would expect given fixed costs are incurred regardless of the level of demand.

169. Notwithstanding the reasons for the decline in total demand, Telstra has a legitimate business interest in recovering the unit costs of providing fixed line access services, irrespective of whether they may be higher under a lower service/demand base than they have been in the past.

170. Professor Sappington observes that the Commission is aware that its approach to cost allocation will result in under-recovery of common costs and notes that it is inappropriate to hold an access provider responsible for changes in demand that are exogenous:[119]

> *[e]ven though changes in consumer demand for fixed line services may not affect cost allocation factors and estimated unit costs,* ***these demand changes can have a profound impact on Telstra's revenues from access services and on Telstra's ability to recover its common costs.***

And

> *The ACCC appears to be aware of this under-recovery of common costs when it suggests that it is not "appropriate to compensate Telstra for any loss of market share, or reduced customer demand for, fixed line services (ACCC, 2011, p. 161). It can be inappropriate to compensate a supplier when poor service quality or other factors directly within the supplier's control cause the demand for the supplier's products to decline.* ***In contrast, it generally is inappropriate to hold a supplier responsible for exogenous changes in demand that are beyond its control. Holding a supplier responsible for such events typically will not improve industry performance, but will impose undue risk on the supplier, which raises its cost of capital.*** (emphasis added)

171. In light of the above, the Commission must adjust the cost allocation factors for changes in demand over time.

172. The rest of this section is set out as follows:

(a) First, there is an explanation of the cost allocation methodology in the FLSM. The result of this methodology is that Telstra is unable to recover a significant proportion of its revenue requirement.

(b) Second, there is a discussion of the two justifications that the Commission has used to not adjust the cost allocation factors over time for changes in demand – a hotel analogy and that Telstra's business risks would be appropriately compensated in the WACC. The hotel analogy is irrelevant and does not, in fact, support the Commission's approach to cost allocation. It is also incorrect to say that Telstra will be adequately compensated for its business risks in the WACC.

(c) Third, there is a review of the Commission's previous approach, the Australian Energy Regulator's (**AER**) approach and the approach of other regulators to cost allocation. This review shows that the Commission's approach is inconsistent with its previous approach and the approach of other regulators.

(d) Finally, there is a discussion on why the Commission's approach to cost allocation is inconsistent with the legislative criteria.

[119] Sappington Report (Schedule A.1), pp. 11-12.

1.2.2. COST ALLOCATION IN THE FLSM MEANS TELSTRA CANNOT ACHIEVE COST RECOVERY

1.2.2.1. WLR AND ULLS

173. The first illustration of the way the Commission's cost allocation methodology results in Telstra not recovering its costs is in the context of WLR and ULLS prices. This can be seen in the FLSM in the spreadsheet titled "D. Geo Cost-based Pricing".

174. In spreadsheet D, the Commission calculates the price of WLR and ULLS. The price of WLR is set on the basis of the average of the WLR unit costs in Bands 1, 2, 3 and 4. Similarly, the price of ULLS is set on the basis of the average of the ULLS unit costs in Bands 1, 2 and 3. The unit cost for any band is the sum of three unit cost components: Ducts and Pipes, Copper Cables, and Indirect Costs.[120]

175. The unit costs for Ducts and Pipes (D 3.1) and the unit costs for Copper Cables (D4.1) are calculated with reference to the total demand figure in D1.2. These unit cost components are calculated as follows:[121]

$$\frac{\textit{The total revenue requirement in each year}}{\textit{Total SIOs in 2009/2010}}$$

176. That is, in each year, the revenue requirement for ducts and pipes and copper cables are allocated to WLR, ULLS and "Residual" on the basis that the total number of SIOs remains constant (see D.3 and D.4). When the total number of SIOs is declining, access prices determined by the FLSM will not recover the Commission's DAC unless those declines are offset by increased volumes elsewhere (which in this instance is not the case). Instead, a proportion of the revenue requirement will be allocated to services that are no longer purchased and hence cannot contribute to overall cost recovery.

177. Telstra suggests that a better approach than that adopted by the Commission would be to change the formula in the FLSM so that the revenue requirement for any year is divided by the total number of SIOs in the same year.

178. Changing the formula as suggested has a material impact on prices for WLR and ULLS. Using Telstra's forecasts that were provided to the Commission on 18 May 2011, which decline over time, would result in an increase in the average ULLS price in Bands 1–3 of $0.69 per month and an increase in the WLR price of around $0.81 per month (Table 4).

[120] FLSM, *Spreadsheet D. Geo Cost-based Pricing*, D.6.3.

[121] FLSM, *Spreadsheet D. Geo Cost-based Pricing*, D.3.1 and D.4.1.

Table 4: Materiality of accounting for demand decline on the prices for WLR and ULLS[122]

Modeling scenario	ULLS					WLR
	Avg (Band 1-3)	Band 1	Band 2	Band 3	Band 4	Avg
FLSM accounting for demand decline	$17.44	$4.91	$15.74	$24.74	$52.40	$23.27
FLSM	$16.75	$4.80	$15.13	$23.72	$50.10	$22.47

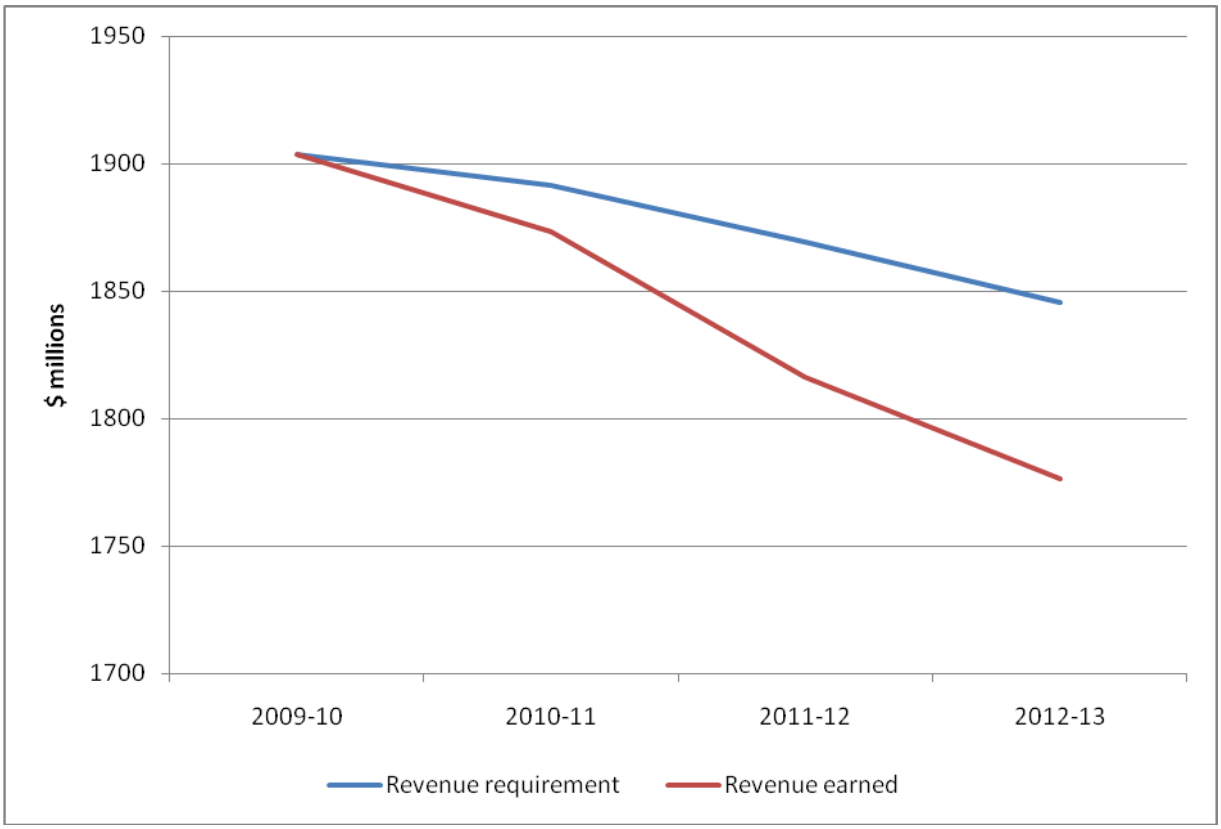
179. Telstra requested that KPMG assess the materiality of the impact on Telstra's revenues if the decline in demand was taken into account in the FLSM. Telstra provided KPMG with the same forecasts that it provided the Commission in its letter of 18 May 2011. The results of KPMG's analysis are set out in its report (**KPMG Report**) (see Schedule A.5). The KPMG Report concludes that the difference between the revenue earned and the revenue requirement for CAN Ducts and Pipes and CAN Copper Cables (ie the two asset classes allocated to ULLS and WLR services) amounts to over $140 million over the three years for which alternative demand volumes were provided (2010/11 to 2012/13).

180. Based on the KPMG Report, Telstra will not be able to recover over $140 million over three years.

181. Figure 7 shows the gap between the revenue earned and the revenue requirement for Ducts and Pipes and Copper Cables.

[122] Refer to Schedule A.9 for further explanation of the sensitivity analysis.

Figure 7: Difference between revenue requirement and revenue earned for ULLS and WLR



1.2.2.2. PSTN OTA

182. The second illustration of the way the Commission's cost allocation methodology results in Telstra not recovering its costs is in the context of PSTN OTA prices. This can be seen in the FLSM in the spreadsheet titled "E. Allocation Factors Calc".

183. The price of PSTN OTA is set by dividing the total revenue requirement allocated to OTA in any year by the total OTA minutes in the same year.[123] The total revenue requirement allocated to OTA in any year is the sum of the revenue requirements relating to each Core asset category.[124] Three of these Core asset categories are local, trunk and other switching. For these asset categories, the revenue requirement allocated to OTA is based on the following calculation:

$$(Total\ revenue\ requirement\ for\ switching\ assets\ in\ year\ t) \times \frac{Total\ OTA\ minutes\ in\ year\ t}{Total\ minutes\ in\ 2002/2003}$$

184. Similar to the case with WLR and ULLS, for PSTN OTA the total revenue requirement is allocated to the total number of minutes in 2002/2003 and then used to determine allowed revenues in the current year (ie the year t in the formula). In effect, this amounts to calculating a unit charge which would recover allocated costs in the base year, and then multiplying that unit charge by the number of minutes in the current year.

185. The consequence of this calculation is that when the total number of minutes is declining, prices calculated in the FLSM will not recover the revenue requirement. As the unit cost is

[123] FLSM, *Spreadsheet 7. Service Costs and Prices*, 7.2.2.

[124] FLSM, *Spreadsheet 7. Service Costs and Prices*, 7.3.1.

not being escalated as volumes decline, the product of a given base year unit cost and current year minutes will fall over time. As a very small share of costs are traffic-dependent[125], the result will be to grossly understate the revenues needed for cost-recovery.

186. The magnitudes involved are large. The total number of minutes in 2009/10 (around 47 billion as shown in row 119) was 28% of the total number of minutes in 2002/03 (around 165 billion as shown in row 87). The Commission's unit cost calculation means that a large proportion of the revenue requirement will be allocated to minutes that are no longer purchased.

187. A suitable remedy would be to change the formula in the FLSM so that the revenue requirement for any year is allocated on the basis of total minutes for the relevant year, not 2002/03.

188. Changing the formula as suggested has a material impact on prices for PSTN OTA. Using the total minutes for the relevant year in row 119 of that spreadsheet, which decline over time, would result in an increase in the PSTN OTA price of 1.1c (Table 5).

Table 5: Materiality of accounting for demand decline on the prices for PSTN OTA[126]

Modelling scenario	PSTN OTA
FLSM accounting for demand decline	2.1c
FLSM	1c

189. KPMG also assessed the materiality of accounting for demand decline for PSTN OTA. The KPMG Report concludes that the difference between the revenue earned and the revenue requirement for Core switching assets amounts to over $1.98 billion over the seven years for which alternative demand volumes were used.

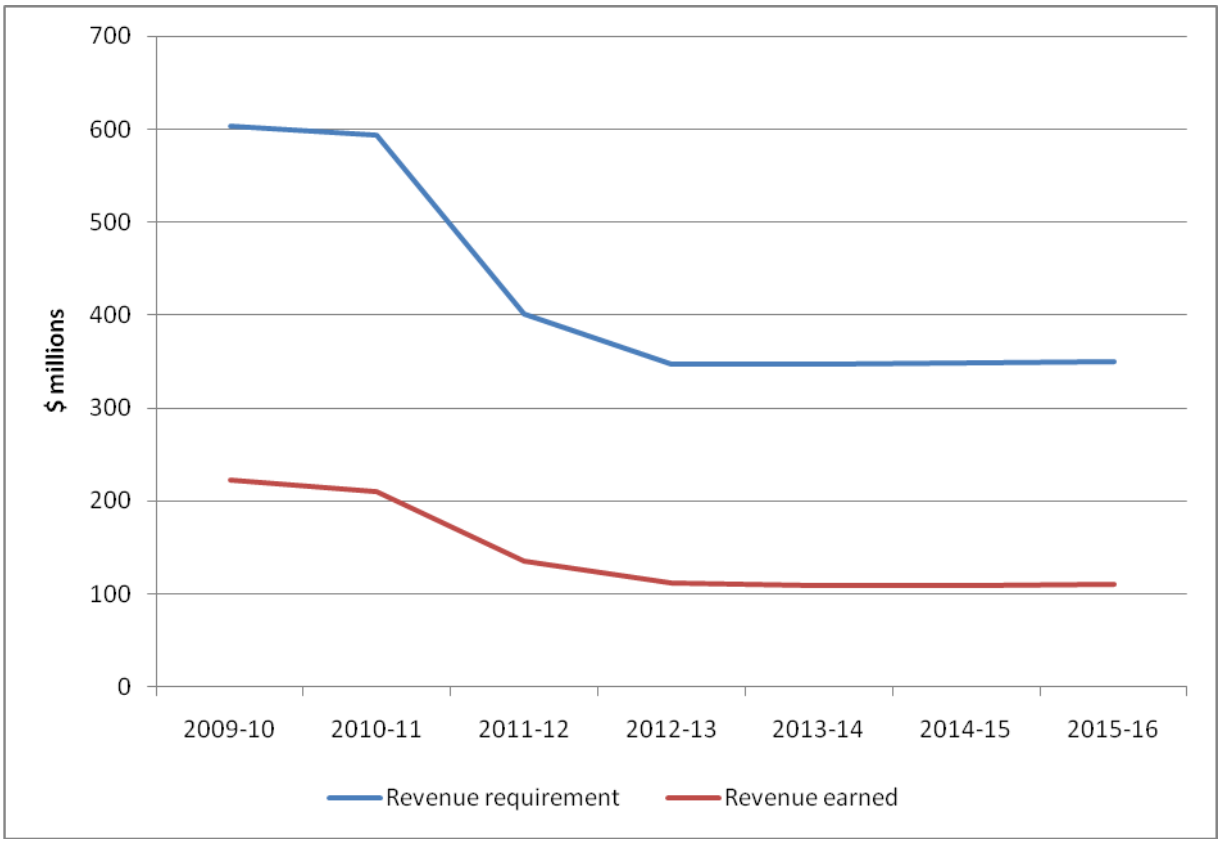
190. Based on the KPMG Report, the amount that Telstra cannot recover over the five year regulatory period is $1.5 billion.

191. Figure 8 shows the gap between the revenue earned and the revenue requirement for local, trunk and other switching equipment.

[125] For instance, the ACCC previously found that total Core (conveyance) costs were relatively insensitive to demand, and average costs sensitive to demand: "For example, a 10 per cent increase in the number of calls produces only approximately a 1 per cent increase in total conveyance costs. A 10 per cent increase in the number of call minutes (say under the assumption of greater call holding times) produces only approximately a 0.6 per cent increase in total conveyance costs. Generally this means that for a given increase in traffic, transport costs per minute of traffic will fall. (ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p. 47).

[126] Refer to Schedule A.9 for further explanation of the sensitivity analysis.

Figure 8: Difference between revenue requirement and revenue earned for PSTN OTA



1.2.3. THERE IS NO BASIS FOR THE COMMISSION TO STRAND TELSTRA'S INVESTMENT AND OPERATING COSTS

192. The result of the Commission's approach is that Telstra cannot recover actual (unindexed) historic investment costs or forward-looking operating and capital expenditure. This approach is supported solely on the basis that to allow Telstra to recover its costs over a declining customer and service base involves "compensating Telstra for a loss of market share". [127]

193. Adjusting the cost allocation factors for changes in demand does not, as the Commission notes, "compensate Telstra for a loss in market share".[128] This is because such an adjustment would not have this effect. Instead it would simply allow Telstra to recover its investment costs that it made in the past as well as its forward-looking "actual costs".

194. The Commission's approach to valuing the initial RAB is inconsistent with its approach to cost allocation. The Commission ignores a forward–looking optimised replacement cost methodology consistent with past regulatory decisions which would reflect the value of Telstra's investment, in favour of an approach which is said to at least allow recovery of actual historic investment costs over time (together with a commercial return). However, the Commission employs a cost allocation methodology that, in effect, introduces a process of optimisation by not allocating costs based on actual demand, but by reference to peak demand that is held constant over time (resulting in costs being simply allocated to non-existent services/calls).

[127] Discussion Paper, p. 127.

[128] Discussion Paper, p. 127.

195. Another inconsistency with the Commission's approach to cost allocation is that it uses the "peak" demand year for PSTN traffic, being 2002/2003, and not the same "peak" demand year for SIOs (instead the Commission uses 2009/2010 demand).

196. Further, the assertion underpinning the Commission's assumption that demand should remain constant over time—being that "[m]uch of the fall in total demand for fixed line services reflects reduced demand for Telstra's retail services"[129]— is not correct. There are a plethora of reasons why both SIOs and PSTN traffic have declined over time.

197. One important reason for a decline in SIOs that the Commission did not identify in its Discussion Paper relates to the situation where customers abandon the use of one of their fixed lines. While previously customers had two lines for their services – one for their home phone, the other for their facsimile or dial up internet service – now customers can receive all these services (phone, broadband, facsimile) over the one line. Some customers have abandoned fixed line altogether and use mobile phone and wireless internet services.

198. Another key reason for a decline in SIOs over time is the impact of fixed to mobile substitution. Despite the Commission's previous view that the CAN bears natural monopoly characteristics and services provided over mobile networks are not substitutable,[130] the Commission refers to this as a "loss of market share".

1.2.3.1. THE ANALOGY OF A HOTEL IS IRRELEVANT AND DOES NOT SUPPORT THE COMMISSION'S APPROACH TO COST ALLOCATION

199. The Commission has used an analogy of a hotel to support its reasoning that adjusting the cost allocation factors for changes in demand is not required as to do so would "compensate Telstra for a loss of market share"[131]

200. While it is not outlined in the Discussion Paper, the Commission has explained its hotel analogy in discussions with Telstra. The proposition is that Telstra's network is equivalent to a hotel that has over-dimensioned its premises. In a competitive market, the Commission argues that a hotel would not be able to increase its room rates so as to recover losses associated with having unoccupied rooms.

201. The hypothetical hotel may bear the loss on the downside; however, even in a workably competitive market, its room rates would rise above resource cost as occupancy levels increased. This reflects the fact that capacity is relatively fixed in the short term, and that short run marginal costs – in this instance, the opportunity cost of not having a room available, should a customer with a high willingness to pay want to occupy a room – are typically steeply upward sloping. In the resulting equilibrium, the hotel fully covers its expected capacity costs, though the capacity charge may only be borne by a relatively small number of occupancies. This is conceptually similar to the situation in the wholesale electricity market, where the steeply upward sloping nature of the supply curve ensures the fixed costs of base-load generators are largely covered in a small number of peak demand hours.

202. What the Commission proposes in the FLSM is, however, entirely different. In the FLSM, unit costs would not be set so as to generate an expected return equal to the WACC, as the central level of the demand forecast will not recover total costs. This is because under-

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[129] Discussion Paper, p. 127.

[130] For example, the ACCC stated in its *Fixed Services Review Declaration Inquiry Fixed Services Review Declaration Inquiry for the ULLS, LSS, PSTN OA, PSTN TA, LCS and WLR*, Final Decision, July 2009 that: In light of the above, the ACCC continues to take the view that mobile services are only an effective substitute for fixed line voice services in a small percentage of cases. For most consumers, the two platforms are seen as complements rather than substitutes. This is due to a range of factors, including costs associated with mobile services, the inconsistency of call quality and consumer practice. However, the ACCC continues to actively monitor consumer behaviour and preferences in this regard.

[131] Discussion Paper, p. 127.

recovery of fixed costs in periods of low demand is not offset by expected over-recovery of those costs at peak periods. Rather, the predictable trend of demand implies a falling degree of cost recovery. It is clear that such an approach cannot be justified.

203. A hotel is not a regulated asset, and it can vary its rates as capacity rises and falls, offering lower rates when it has many unoccupied rooms and charging higher rates as it nears capacity. Unlike the hypothetical hotel Telstra cannot recover the full value of its "room" by varying charges with capacity as it is regulated in respect of the returns it can recover from any particular "room".

204. The User Manual for the FLSM, contains a note that the switching equipment in the Core network has been "over provisioned" and therefore the Commission contended that the 2002/03 demand estimate represents peak demand.[132]

205. There is no evidence that Telstra over-provisioned its network. Telstra has had an obligation to service areas, and has provisioned its network so as to meet reasonably anticipated demand for wholesale services. Indeed, throughout the period of forward-looking costing from 1997 to 2010, the Commission has adjusted network dimensions in accordance with its own estimates of expected demand, not Telstra's estimates. Further, the costs subject to this allocation rule are mostly fixed and unavoidable, as previously noted by the Commission.[133] The fact that social changes have resulted in declining use of fixed lines and declining fixed line voice calls does not mean that historical investments were imprudent or inefficient.

206. Further, the Commission applies this approach, not only to capital assets, but also to operating and maintenance (**O&M**) expenses and tax expenses. These expenses are directly referable to current demand (O&M is spent to ensure Telstra's network is operating for current customers and tax expenses are paid on margins earned in a particular year). It is inappropriate, therefore, to allocate a proportion of those expenses to usage in earlier years, particularly when that usage no longer exists in later years. Even an "overprovisioned" hotel would seek to recover its operating costs from the rooms sold, not from unoccupied rooms.

1.2.3.2. TELSTRA WILL NOT BE ADEQUATELY COMPENSATED THROUGH THE WACC

207. In the Discussion Paper, the Commission contends that "Telstra has been appropriately compensated for its business risks through the risk premium included in the commercial rate of return provided by the WACC."[134] This contention is incorrect on two levels – a factual level and a principled level.

208. As noted below in section 2.2.5, the fact is that the Commission's previous approach to cost allocation under the TSLRIC+ framework was to account for demand changes over time. Accounting for demand changes meant that unit costs and access prices changed over time. During this period, the relevant WACC parameters that account for business risk – asset beta and equity beta – were unchanged for nine years (Table 6). In 2010, the Commission decreased the values of the asset beta and equity beta which suggests that its view is that Telstra faced less risk, including demand risk, than it has faced in the past.

[132] ACCC, *User Manual for the FLSM*, p. 16.

[133] ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p 47.

[134] Discussion Paper, p. 127.

Table 6: Asset beta and equity beta values over time

Date of decision	Asset beta	Equity beta
July 2000[135]	0.5	0.83
October 2003[136]	0.5	0.83
August 2006[137]	0.5	0.83
April 2009[138]	0.5	0.83
August 2009[139]	0.5	0.83
September 2010[140]	0.42	0.7

209. In 2000, when the asset beta of 0.5 and the equity beta of 0.83 were set, the Commission noted that:[141]

> *For demand related risks, the Commission has not been provided with any evidence by Telstra to persuade it that the PSTN is subject to any unique demand related risks. If anything, the Commission has indicated in the previous undertaking assessment that* ***demand for the PSTN should be fairly stable into the foreseeable future such that there is a limited likelihood of any down-side risk in this regard****. (emphasis added)*

210. This view was maintained by the Commission until 2010 when it was decided that the asset beta and the equity beta were to be reduced. To justify the reduction in the betas, the Commission stated that:[142]

> *The systematic risk associated with business lines like mobile communications is likely to be significantly higher than the systematic risk associated with fixed line services. Since the benchmarked firms provide both fixed and mobile networks, the benchmark asset beta is likely to be higher than the asset beta of Telstra's CAN alone... Furthermore, the ACCC has in the past stated that an asset beta value of 0.5 for Telstra is conservative since the systematic risk of the fixed line services is likely to be less than Telstra's operations as a whole.*

211. That is, the Commission stated that it had previously applied the beta values of Telstra's business generally – both fixed and mobile services – but now was *lowering* the beta values on the basis that the risks related to demand for PSTN services were in fact lower than those faced by Telstra generally.

212. If the Commission is accounting for demand risks in the WACC, as it is contended, then the Commission must consider that the demand risk on the PSTN is considerably lower than what it was in 2000 when they said that PSTN demand "should be fairly stable into the foreseeable future". This is simply wrong.

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[135] ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p. 21.

[136] ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p. 39.

[137] ACCC, *Draft Unconditioned Local Loop Service Pricing Principles and Indicative Prices*, April 2008, p. 9.

[138] ACCC, *Assessment of Telstra's Unconditioned Local Loop Service Band 2 monthly charge undertaking Final Decision*, Public Version, April 2009, p. 229.

[139] ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, August 2009, p. 72. .

[140] September 2010 Draft Report, p. 73.

[141] ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p. 21.

[142] September 2010 Draft Report, p. 72..

213. There is also no evidence in the Discussion Paper to suggest that the Commission has adjusted the WACC to account for demand risk. Professor Sappington notes that:[143]

> *In principle, the ACCC could compensate Telstra for bearing the full risk associated with exogenous declines in the demand for fixed line services. The ACCC could do so by explicitly increasing Telstra's weighted average cost of capital (WACC), thereby authorizing higher prices for Telstra's regulated services. The ACCC suggests it may have done so. However, the ACCC's 2011 Discussion Paper presents no evidence to support this suggestion nor does it attempt to quantify the compensation that Telstra has been afforded in this regard.*

214. At a principled level, the Commission's contention is confused. Specifically, the contention confuses the cost of capital with the cash flows to which it is being applied.

215. The Commission has consistently determined the risk premium by use of the Capital Asset Pricing Model (**CAPM**). Without reviewing the merits and demerits of the CAPM, it is clear that it can only be used if the cash flows being discounted correspond to the CAPM's assumptions. Those expected future cash flows being discounted must generally come from a stationary normal distribution.

216. Moreover, for a regulated firm, the expectation of that distribution should in principle equal cost recovery (in other words, the distribution of cash flows should be such that cash flows are as likely to exceed total costs as to fall short of them) – in expectation, the firm should, in other words, earn zero economic profits. This criterion applies equally to forward-looking costing and to building blocks approaches to cost determination.

217. However, those conditions are not met under the approach now being proposed. Rather, on what is now known about likely levels of demand, the expectation of the cash flows determined under the Commission's approach would be less than total costs. As a result, the expectation of net cash flows is not zero. There is no sense in which the risk premium as determined under the CAPM can compensate investors for that fact.

218. Moreover, as demand forecasts are pegged to levels that are almost certain not to be exceeded (but rather, are inherently excessive), it is more likely that cash flows would fall short of that expectation than they would exceed them. This asymmetry aggravates the extent of the under-compensation that will be provided by the risk premium under the CAPM.

219. Finally, the Commission's approach could result in a standalone firm providing the fixed line services becoming insolvent. This is because, despite the Commission's allocation approach, the standalone firm would still need to incur the total O&M expenses, pay all income taxes, and service the debt and book depreciation relating to the total capital amount.

220. This is obvious in the case of a firm that was entirely debt financed. As the mechanical effect of the Commission's allocators (which are pegged at or close to peak demand levels) is to ensure costs in the period of declining demand are under-recovered, the firm would recover costs only during the relatively short period when demand was at, or close to, its peak. As a result, the debt burden could not be serviced once that period was over and demand began to decline, forcing the firm into liquidation. Of course, the threat of insolvency diminishes as the firm's leverage declines, but the point is that the Commission's approach would prevent a firm from operating with an efficient level of leverage – indeed, would make it extraordinarily risky for the firm to operate with the levels of leverage the Commission has long imputed to Telstra.

221. In summary, the Commission's position with respect to dealing with demand changes in the WACC is factually incorrect and inconsistent with the principled logic of both the BBM and the CAPM.

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[143] Sappington Report (Schedule A.1), p. 12.

1.2.4. ONLY ALLOWING FOR DEMAND RISKS IN THE WACC IS INCONSISTENT WITH THE AER'S APPROACH

222. In regulation of energy businesses, the AER does not make any assumption of stable demand or constant unit costs. Notwithstanding the inclusion of risk premia in the WACC, the AER takes into account demand changes throughout the regulatory period.[144] The AER's demand forecasts takes into account a range of factors, including population growth, development of energy-efficient appliances, Government policy in relation to energy usage and substitution to alternative energy sources.

223. Electricity distribution businesses develop peak demand forecasts (which underpin capex forecasts) and sales forecasts (which are used to allocate costs and derive tariffs), which are subject to review and approval by the AER. The derivation of sales forecasts typically involves two steps:

- econometric modelling is used to identify historic drivers of energy demand (eg population growth, GDP per capita, price, weather patterns etc) and develop a baseline forecast based on these key drivers; and
- post-model adjustments are made to the baseline forecast for new Government policies or other factors that are unlikely to be captured by the econometric models.

224. The post-model adjustments can (and typically do) include downward adjustments to the baseline forecast to reflect generally lower energy usage flowing from various Government policy initiatives and/or substitution to alternative energy sources. Examples of post-model adjustments approved in recent AER electricity determinations include:[145]

- reductions in demand to account for expected increases in installation of solar photovoltaic units;
- expected reductions in demand as a result of the introduction of minimum energy performance standards (**MEPS**) for various appliances such as televisions and air-conditioners;
- expected increases in demand from electric vehicles;
- expected reductions in demand due to the impact of the (now abandoned) Federal Government insulation program; and
- reductions in demand to reflect the expected impact of the (now abandoned) carbon pollution reduction scheme (**CPRS**).

225. While some of these adjustments reflect the impact of broad-based energy efficiency schemes (eg the adjustments for MEPS and the insulation program), others reflect expected substitution to other technologies such as solar.

226. The post-model adjustments approved by the AER can in some cases be quite significant. For example in the AER's May 2010 distribution determination for ETSA Utilities, a range of post-model adjustments were made to the baseline sales forecast (Table 7).

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[144] It is also notable that energy businesses are typically allowed a higher risk premium than what is proposed for Telstra. This is largely due to the lower credit rating used to derive the debt risk premium for energy businesses (BBB+ and BBB).

[145] See for example: AER, *Final Decision: Victorian electricity distribution network service providers distribution determination 2011–2015*, October 2010, pp 92-108; AER, *Final Decision: South Australia distribution determination 2010-11 to 2014-15*, May 2010, p 64.

Table 7: AER allowed post-model adjustments for ETSA Utilities' energy sales forecast (GwH)

Adjustment categories	2010–11	2011–12	2012–13	2013–14	2014–15
Electric vehicles	6.4	12.5	18.6	24.8	31.1
REES scheme	-9.9	-15.6	-21.3	-27.1	-32.8
Insulation program	-16.5	-17.2	-17.8	-17.8	-17.8
Air conditioner MEPS	-3.2	-6.4	-9.6	-2.9	-16.2
Televisions and STUs	27.5	41	20.2	-8.9	-36.6
Standby power	-29.5	-44.2	-58.8	-73.4	-88
Solar PV panels	-18	-24.7	-30.7	-35.4	-38.8
Lighting MEPS	-108	-137	-163	-175	-179
Total adjustment	-151.2	-191.6	-262.4	-325.7	-378.1

Source: AER, *Final Decision: South Australia distribution determination 2010-11 to 2014-15*, May 2010, p 64

227. Whilst there was some dispute over the appropriate size of these adjustments, the AER generally agreed with ETSA Utilities that post-model adjustments were required to account for factors affecting demand for network services over the regulatory period that were not accounted for in baseline forecasts. In respect of MEPS and solar photovoltaic units for example, the AER stated:[146]

> *The AER agrees with AEMO's conclusion that adjustments are warranted in relation to the rising penetration of small scale solar PV units, and the recently introduced policy to tighten MEPS applying to lighting appliances, as these policy effects have the potential to significantly change the existing profile of demand. Therefore the AER accepts ETSA Utilities' post model energy efficiency saving adjustments in relation to these two areas.*

228. The AEMO Report had concluded in relation to solar units:[147]

> *AEMO believes that adjustments are warranted in relation to the rising penetration of small scale solar PV units… [because] roof top solar PV units have the potential to make a reasonably large contribution to residential users' net energy requirements from the shared grid, particularly over the longer term if the current high rates of growth continue over a decade or more.*

229. Partly as a result of these adjustments, the approved sales forecast for ETSA Utilities showed a slight decline in usage over the regulatory period, despite population growth and increasing customer numbers.[148] The AER decision resulted in real increases in retail prices over the five-year regulatory period.[149]

230. Similar to electricity, gas distribution businesses are required to provide the AER with demand forecasts. Rules 72(1)(a)(iii) and 72(1)(d) of the National Gas Rules (NGR) provide that the access arrangement information for a full access arrangement proposal for a distribution pipeline must include:

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[146] AER, *Draft Decision: South Australia draft distribution determination 2010-11 to 2014-15*, November 2009, p 94.

[147] AEMO, *Review of ETSA Utilities sales and demand forecasts*, October 2009, p 33.

[148] AER, *Final Decision: South Australia distribution determination 2010-11 to 2014-15*, May 2010, p 67.

[149] AER, *Final Decision: South Australia distribution determination 2010-11 to 2014-15*, May 2010, p 252.

- usage of the pipeline over the earlier access arrangement period showing, for a distribution pipeline, minimum, maximum and average demand, and customer numbers in total and by tariff class; and

- to the extent that it is practicable, a forecast of pipeline capacity and utilisation of pipeline capacity over the access arrangement period and the basis on which the forecast has been derived.

231. Methodologies underpinning forecasts for demand typically involve using historical load estimates and making adjustments for:

    - economic factors – such as gross domestic product/gross state product, population growth, dwelling growth and other demographic factors;

    - climatic factors – such as seasonal variation and regional weather patterns;

    - Government policies – such as MEPS for gas hot water systems, energy efficiency home rating schemes, business energy efficiency reporting schemes, the expanded renewable energy target (RET), the BASIX certification system for homes in New South Wales, the Government's (now abandoned) insulation scheme, and hot water rebate schemes for solar and heat pump hot water system replacements; and

    - market trends and substitution – such as trends affecting the uptake of existing gas appliances, including but not limited to, the impacts of installing alternative appliances such as reverse cycle air conditioning in lieu of gas heating, continuous flow gas systems in lieu of storage gas systems, solar or electrical systems, and the impacts of water conservation measures on the consumption of hot water.

232. Demand forecasts are subject to review and approval by the AER under rule 74 of the NGR, which requires the AER to be satisfied that forecasts are arrived at on a reasonable basis and represent the best forecast or estimate possible in the circumstances.

233. Recent decisions of the AER illustrate that, despite not accepting the Service Provider's precise forecasts, it has generally accepted methodologies that adjust demand forecasts over time:

    - in the Final Decision on the Access Arrangement for the NSW Gas Networks, the AER accepted Jemena's forecasts for the first two years of the regulatory period based on a model from NIEIR which accounted for all of the factors listed above;[150]

    - in the Draft Decision on APT Allgas's Access Arrangement for the Queensland Gas Networks, the AER considered that, for the most part, the forecast methodology and the resultant demand forecasts proposed by APT Allgas, which changed over time for a range of reasons, were reasonable;[151] and

    - in the Draft Decision on Envestra's Access Arrangement for the SA Gas Networks, the AER considered that the forecast methodology adopted by Envestra was reasonable (the NIEIR methodology which takes into account the above list of factors).[152]

[150] AER, *Final Decision: Jemena Gas Networks – Access Arrangement Proposal for the NSW Gas Networks – 1 July 2010–30 June 2015*, June 2010.

[151] AER, *Draft Decision, APT Allgas – Access Arrangement Proposal for the Qld Gas Networks 1 July 2011–30 June 2016*, February 2011, p. 109.

[152] AER, *Draft Decision: Envestra Ltd – Access Arrangement Proposal for the SA Gas Networks 1 July 2011–30 June 2016*, February 2011, p. 180.

234. In fact, in the APT Allgas Draft Decision, it was made explicit that demand risk is not accounted for in the WACC:[153]

> *APT Allgas submitted that gas is a 'fuel of choice' and therefore is exposed to competition from alternative energy sources, including electricity which is a fuel of necessity. However, the AER considers that this competition does not expose APT Allgas to more systematic risk. For instance, this competition risk could be mitigated by an investor who holds both electricity and gas distribution stocks.*

235. In summary, an analysis of the AER's approach in gas and electricity shows that, notwithstanding the inclusion of the risk premia in the WACC formula, the AER has adjusted demand forecasts over time to reflect various factors including substitution to alternative technologies (ie electricity to gas and vice versa) and does not adjust the WACC to account for demand risk.

1.2.5. NOT ADJUSTING THE COST ALLOCATION FACTORS FOR CHANGES IN DEMAND IS OUT OF STEP WITH PREVIOUS COMMISSION DECISIONS AND THE APPROACH ADOPTED BY OTHER TELECOMMUNICATIONS REGULATORS

236. In previous pricing decisions under the TSLRIC framework, the Commission has previously noted that unit costs will increase when demand declines and this is factored into the calculation of access prices:

- In a 2003 pricing decision, the Commission noted in relation to PSTN OTA prices that it "understands that in future years there may be significant traffic migration away from the PSTN resulting in an increase in the per minute call conveyance cost".[154]
- In a 2009 pricing decision, the Commission noted "the declining trend in PSTN calls and the implications for increasing unit costs". The Commission then referred to the Analysys cost model which it said "factors in declining demand for PSTN."[155]
- In the same 2009 pricing decision, the Commission stated that it proposed to "estimate unit costs on an annual basis, for 2009-10 and following years" for LSS and ULLS. The Commission further noted that "[t]his will reduce unit costs, as the very high cost, low demand, periods that immediately followed the introduction of the LSS and ULLS are removed from the cost pool".'[156]

237. Further, when it considered Telstra's undertaking for PSTN OTA and LCS in 2009, the Commission noted that it recognised that there are exogenous factors that influence demand which need to be assessed and taken account of in forecasting demand for PSTN OTA services:[157]

> *The ACCC notes Telstra's contention that the proposed substantial increase in PSTN access charges result from an expected declining use of PSTN services and reflect increasing unit costs since cost of the PSTN, including hypothetical efficient costs, are largely fixed. In its model price determination for the core services released in October 2003, the ACCC did note that '..in future years there may be significant traffic migration away from the PSTN resulting in an increase in the per-minute call conveyance cost'.*

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[153] AER, *Draft Decision, APT Allgas – Access Arrangement Proposal for the Qld Gas Networks 1 July 2011–30 June 2016,* February 2011, p. 181..

[154] ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, p. 106.

[155] ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS,* August 2009, p. 34.

[156] ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS,* August 2009, pp. 83–84.

[157] ACCC, *Telstra's Undertakings for the PSTN Originating and Terminating and LCS Access Services*, Discussion Paper, May 2006, pp. 17–18.

The ACCC now notes that there is a sense in which an expectation of declining PSTN volumes may be self-fulfilling to the extent that an increase in future PSTN access prices directly or endogenously reduces demand to some degree. This said, the ACCC recognises that there are also exogenous factors influencing current consumer demand which are likely to continue to affect demand in the future for PSTN services and these need to be assessed and taken account of in forecasting future demand for PSTN services. Telstra's submission and media statement refer to a migration from fixed line services to mobile services and the greater use of broadband for internet and other (including the growing use voice over IP) services, rather than dial-up, as important drivers of declining PSTN product revenues.

The ACCC notes that volume forecasts will be an important element in the calculation of access charges for PSTN services that should apply in the future undertaking period.

238. Therefore the Commission's proposed approach in the FLSM is inconsistent with its previous practice.

239. The Commission's proposed approach is also inconsistent with Ofcom's approach in the UK. Ofcom has recognised PSTN decline and the impact this has on unit costs and therefore access prices:[158]

> *Technology change is likely to mean that some voice telephony traffic migrates from the public switched telephony network (PSTN) to next generation networks (NGNs) during the life of the next control [regulatory period]. Ofcom's approach to this is explained in this consultation document. Also, the volume of calls delivered using wholesale conveyance services provided over BT's network has declined and is forecast to continue on a downward trend. As a result we are forecasting that unit costs will rise during the period of the next NCC. Under the proposals set out in this document, NCC charges would consequently be allowed to rise.*

240. More recently, in its March 2011 Consultation Paper on Network Controls for WLR and LLU, Ofcom accounted for a decline in PSTN demand in the calculation of unit costs and access prices. Ofcom noted a key assumption in its cost modelling is that where total demand for fixed lines falls by 700,000 lines over three years, demand for MPF [equivalent to ULLS] will increase by 1.4 million lines, with 1 million decline in demand for SMPF [equivalent to LSS].[159] In Annex 6 of the Consultation Paper, Ofcom explained that:[160]

> *Future demand projections have an impact on aggregate and unit costs for the following reasons:*
>
> *• the existence of fixed costs means that unit costs will increase if volumes fall, because the fixed costs must be recovered over fewer lines;*
>
> *• shifts in demand (e.g. from WLR to MPF) will result in changes to the profile of cost recovery;*
>
> *… The main trends in our forecasts are as follows:*
>
> *• a reduction in the aggregate demand for fixed lines, from 23.8 million in 2009/10 to 22.7 million in 2013/14;*
>
> *• a substantial shift in demand from WLR to MPF; and*
>
> *• a reduction in demand for SMPF, from 11.8 million lines in 2009/10 to 9.2 million in 2013/14.*

241. In May 2011, Ovum reported that national telecommunications regulators across Europe are increasing ULLS prices to account for, in part, the decline in demand.[161] In particular, Ovum noted that:[162]

> *In November 2010, Italy's AGCOM adopted a new BU-LRIC cost model for access pricing, at the same time revising rates for 2010, 2011, and 2012 to €8.70, €9.02, and €9.28 respectively. This*

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[158] Ofcom, *Review of BT network charge controls – Consultation on proposed charge controls in wholesale narrowband markets*, 19 March 2009, p. 1.

[159] Ofcom, *Charge control review for LLU and WLR services,* Consultation Paper, Non-confidential version, 31 March 2011, p. 98.

[160] Ofcom, *Charge control review for LLU and WLR services,* Annexures, Non-confidential version, 31 March 2011, pp. 39–40.

[161] Other factors include the rise in the price of copper and inflation.

[162] Ovum, *A rise in the cost of unbundling the local loop in Europe*, May 2011, Ovum Opinion, p. 2.

is to compensate the combined effect of higher costs sustained by Telecom Italia and of an estimated 1.5% reduction until 2012 in the number of active fixed lines.

The CMT in Spain followed a similar logic last month in raising the price of access to Telefonica's local loop from €7.79 to €8.32 per month – a 6.8% rise. Following an analysis of Telefonica's accounts for the year 2008, the regulator acknowledged that the operating costs were significantly higher than the regulated price. It also added that the 2009 accounts, still pending approval, seem to confirm a gap between costs and LLU rates, resulting in a loss for the incumbent. However, this is a temporary measure while the CMT awaits the adoption of a BU-LRIC cost model later this year.

1.2.6. THE ALLOCATION OF UNIT COSTS DOES NOT REFLECT A PROPER CONSIDERATION OF THE EVIDENCE OR RELEVANT LEGISLATIVE CRITERIA

242. The Commission has determined unit costs based on historic levels of SIOs and historic "peak" levels of PSTN OTA usage. These values are locked in to the FLSM. In short, the FLSM does not reflect current levels of SIOs or OTA minutes. Nor does it reflect anticipated further substantial declines in SIOs and OTA minutes.

243. The result is that unit costs are understated by reference to actual and forecast SIO and OTA minute levels. The approach is equivalent to allocating costs to SIOs and OTA minutes that are not consumed (and for which no revenue is received).

244. The stated rationale is that to reflect (the reality of) increasing unit costs for Telstra in providing regulated services, is to compensate it for a loss in its retail market share to competitors and that Telstra is compensated for such a loss through its return on capital. These propositions are simply incorrect:

    (a) It is assumed that the decline in PSTN OTA minutes is due to a loss in retail market share. Voice calls may still utilise the fixed line network, including over VoIP, but not use PSTN OTA. A switch from voice calls to other modes of communication, eg online messaging and email, is not reflective of a loss in retail market share.

    (b) To be able to recover real inclining unit costs on its fixed line network because of a decline in usage, is not to be compensated for a loss in retail market share. The Commission's proposition does not follow and lacks rationality.

    (c) Telstra is not compensated for a loss of retail market share (or a decline in SIOs and PSTN OTA usage) through its return on capital.

245. The consequence of this approach is that Telstra cannot recover the value of the RAB as determined by the Commission and will not be able to fully recover future capital and operating expenditure.

246. The Commission's approach to cost allocation does not reflect evidence previously provided showing forecast PSTN decline.[163] Telstra has also provided detailed information from industry commentators and third party analysts showing PSTN decline.[164] Two causes of recent and expected future PSTN decline are well recognised and well documented by industry commentators as including:

    - substitution between fixed and mobile services; and

[163] See, for example, Telstra, *Supplementary submission on demand and cost allocators to the Review of the 1997 telecommunications access pricing principles for fixed line service - draft report,* November 2010, and Telstra, Letter to the ACCC on 18 May 2011.

[164] Telstra, *Supplementary submission on demand and cost allocators to the Review of the 1997 telecommunications access pricing principles for fixed line service - draft report,* November 2010.

- increased penetration of IP/broadband-based telephony.[165]

247. In short, the Commission's model does not reflect the actual evidence of total SIOs and OTA minutes, but rather a historical level of total SIOs and OTA minutes, based on history.

248. The approach is both novel and unorthodox. It is without regulatory precedent and is directly inconsistent with the approach of the Commission in the past and other regulators. Telstra has identified previous Commission decisions, AER decisions and decisions made by Ofcom and other regulators where the decline in demand is taken into account such that unit costs and access prices increase over time.

249. It is also arbitrary as there is no reason or evidence to support setting total demand to the levels in 2002/2003 or 2009/2010. In particular, the approach entails ignoring the clear evidence of declining PSTN usage and increasing unit costs.

250. Even if the Commission's initial RAB valuation allowed Telstra to recover the economic value of its investments (which it does not), the cost allocation methodology which holds demand constant prevents Telstra from recovering its costs/revenue requirement, without any sufficient justification.

251. The KPMG Report illustrates that, by holding demand constant, the Commission is preventing Telstra from recovering a large portion of its costs. The KPMG Report shows that there is $1.5 billion of Core switching assets that are not allocated appropriately to PSTN OTA services and over $140 million of CAN and IEN assets that are not allocated appropriately to ULLS and WLR services. The materiality of this non-cost recovery is not given any consideration by the Commission.

252. The resulting decision accordingly does not reflect an adequate or proper consideration of:

    (a) the impact on the incentives for investment in infrastructure if the Access Provider cannot recover its costs based on actual levels of network usage, resulting in a material non-recovery of its direct costs;

    (b) Telstra's legitimate business interests in recovering the value of its past and future investments and its direct operating costs through prices for declared services; and

    (c) Telstra's legitimate business interest in not being subject to ad hoc and arbitrary cost allocation methodologies.

253. Accordingly, consistent with its previous submissions to this consultation process[166] , Telstra submits that the Commission's cost allocation factors must be adjusted over time to account for changes in demand over time.

[165] Telstra, *Supplementary submission on demand and cost allocators to the Review of the 1997 telecommunications access pricing principles for fixed line service - draft report,* November 2010, p. 5.

[166] See, for example, Telstra, Submission to the Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services Discussion Paper – December 2009, 26 February 2010, p. 29.

2. OTHER COSTS ARE NOT PROPERLY REFLECTED IN THE FLSM

2.1. The return on capital is understated by the Commission

Key points:

The Commission's proposal in respect of the WACC risks depriving Telstra of reasonable return on capital.

The equity beta does not properly reflect the commercial risks faced by Telstra and needs to be updated in line with the expert advice of PwC.

The Commission's new approach to estimating the debt risk premium is overly simplistic and out of step with previous regulatory practice.

The assumed value of imputation credits (gamma) is overstated and must be updated in line with the recent decision of the Australian Competition Tribunal.

2.1.1. EQUITY BETA

254. In the 2010 Draft Report and in the Discussion Paper, the Commission proposes to reduce Telstra's asset beta to 0.42, implying an equity beta of 0.7 (based on the Commission's gearing assumptions). Prior to the 2010 Draft Report, the Commission had consistently taken the view that an appropriate asset beta for Telstra was 0.5, implying an equity beta of 0.83.

255. For the reasons set out in Telstra's response to the 2010 Draft Report[167] and the reasons below, Telstra considers that the Commission has not sufficiently justified its decision to reduce the equity beta for Telstra.

256. The Commission stated in its earlier decisions adopting an asset beta of 0.5 that it considered this was an appropriate reflection of the systematic risks associated with the PSTN at the time. The Commission appeared to consider that the risk to PSTN cash flows was relatively low, given that demand for PSTN services appeared to be stable. For example in its July 2000 decision on Telstra's 1999 PSTN undertaking the Commission states:[168]

> *With regard to Telstra's argument that the asset beta should be increased to take account of diversifiable risks, the Commission is not convinced of the need to increase the asset beta in this instance. For demand related risks, the Commission has not been provided with any evidence by Telstra to persuade it that the PSTN is subject to any unique demand related risks. If anything, the Commission has indicated in the previous undertaking assessment that demand for the PSTN should be fairly stable into the foreseeable future such that there is a limited likelihood of any down-side risk in this regard.*

257. The Commission now states that these earlier decisions were establishing a beta for Telstra generally, and that the beta for the PSTN specifically should be lower.[169] However it is clear from the quote above and from later decisions[170] that the Commission was establishing a

[167] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp 86-87

[168] ACCC, *A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services*, July 2000, p 91

[169] Draft Report, p 72

[170] For example: ACCC, *Assessment of Telstra's ULLS monthly charge undertaking: Final Decision*, August 2006, pp 114-115

beta which it thought reflected the risks associated with the PSTN (Telstra has consistently argued that the Commission's beta understates these risks).

258. The Commission also states in the 2010 Draft Report that its decision to reduce the beta is in line with other decisions of the Commission and the AER for other utilities, including the decision of the AER to apply an equity beta of 0.8 for electricity transmission and distribution businesses.[171] On this point, it is not clear to Telstra how these decisions for other utilities are relevant, given the different degree and nature of risk faced by these businesses. For example electricity network businesses are unlikely to face the same level of demand risk as Telstra and therefore represent inappropriate benchmarks for the determination of beta.

259. Telstra has difficulty understanding how the systematic risk associated with the PSTN could now be lower than it was a decade ago, as implied by the Commission's decision to reduce the asset beta from the level it adopted in July 2000. A decade ago, the competitive threat from alternative networks (including mobile networks) was not nearly as great and the significant industry reforms now underway had not been contemplated. As the Commission noted in its July 2000 decision, demand for the PSTN was expected to be fairly stable into the foreseeable future.

260. Telstra submits that the level of systemic risk associated with the PSTN business is in fact greater now than it was a decade ago when the Commission determined the equity beta to be 0.83. This is for a number of reasons, including:

    (a) advances in wireless technology and associated increases in the competitiveness of wireless services;

    (b) changing consumer preferences, including a shift away from traditional switched voice services; and

    (c) risk to PSTN cash flow as a result of the pending NBN rollout and associated industry reforms.

261. In these circumstances there is certainly no justification for a reduction in the equity beta. Rather, the equity beta should be increased to reflect the increased systematic risk now associated with the PSTN business.

2.1.2. DEBT RISK PREMIUM

262. In the Discussion Paper, the Commission proposes a significant change in its approach to estimating the debt risk premium (**DRP**). The Commission proposes to use the yield on a single bond issued by Telstra as the sole basis for its DRP estimate.[172]

263. Prior to the Discussion Paper, two alternative approaches to estimating the DRP had been proposed:

- Telstra had proposed a Telstra-specific DRP based on the average Telstra corporate bond rate sourced from eight independent banks; and

- The Commission had proposed in the 2010 Draft Report to rely on the Bloomberg A-rated fair value curve, extrapolated from 7 to 10 years based on the spread between the AAA-rated 7 and 10-year Bloomberg fair value estimates.[173]

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[171] Australian Energy Regulator, *Electricity transmission and distribution network service providers: Statement of the revised WACC parameters (transmission) and Statement of regulatory intent on the revised WACC parameters (distribution)*, May 2009

[172] Discussion Paper, pp 97-98

[173] Draft Report, pp 73-74

264. The Commission's approach in the 2010 Draft Report yielded a DRP estimate of 307 basis points, which was consistent with the range of estimates produced by the Telstra methodology.

265. The Commission's sudden shift to a new methodology relying on a single bond yield results in a reduction of the DRP to 219 basis points. There is no reasoning to justify this significant reduction in the DRP based on an entirely new methodology.

266. Reliance on a single bond to estimate the DRP has the potential to introduce a significant risk of error, since no two bond issues will be the same, and the observed yield on a particular bond will be influenced by many factors, not just the risk profile of the issuer.[174] In recognition of this, the DRP is typically measured by reference to sources of information which amalgamate multiple bond issues. The alternative approaches previously proposed by the Commission and Telstra are examples of this – the Commission (consistent with the practice adopted by the AER) has sought to rely on a fair value curve which takes into account multiple bond issues of a particular maturity, while the Telstra approach takes the average Telstra corporate bond rate sourced from eight independent banks.

267. The risks of relying too heavily on a single bond issue have recently been recognised by the AER in its electricity distribution determination for Victoria. In making its determination the AER wished to utilise information from a bond recently issued by the Australian Pipeline Trust (APT bond). The AER placed some weight on the APT bond yield in its final decision, with the most weight (75%) being placed on the fair value estimates from Bloomberg (with the fair value curve extrapolated out to 10 years as the Bloomberg curve only extended to seven years, as in this case). The AER stated in its final decision:[175]

> *…the AER acknowledges the arguments presented by the DNSPs regarding the reliability of Bloomberg, and the uncertainty surrounding the APT bond as a single observation. For this reason, the AER has maintained its proposed approach of using the yields derived from Bloomberg and from the APT bond. The AER has given more weight to the former for the purposes of this final decision. In forming this decision, the AER recognises that Bloomberg is demonstrated to accurately represent yields on shorter rated BBB bonds, while yields on the APT bond reflect an observed yield on a 10 year BBB bond which may be reflective of the efficient cost of debt for regulated network service providers. However, this is only one observation whilst the Bloomberg fair value curve is reflective of a range of BBB rated bonds.*
>
> *Consequently, the AER considers that a 75% and 25% weighting to Bloomberg and APT respectively reflects a reasonable and practical approach in setting the DRP given uncertainties around relying too heavily on the single observation in the APT bond with respect to the benchmark corporate bond rate.*

268. Telstra submits that the Commission should be similarly cautious in relying too heavily on a single bond observation in determining the cost of debt for Telstra.

269. As set out in Telstra's submission on the 2010 Draft Report, the best estimate of Telstra's actual cost of debt is the Telstra-wide DRP, which is based on the average Telstra corporate bond rate sourced from eight independent banks. This provides an estimate of Telstra's actual cost of debt based on independently sourced information, and does not simply rely on a single bond yield. The Telstra methodology also does not rely on the extrapolation of the Bloomberg fair value curve, which the Commission now says "causes problems". It is not apparent from the Discussion Paper why the Telstra-wide DRP cannot be relied upon to estimate the actual cost of debt for Telstra.

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[174] For example, yield may be affected by various non-standard features of the bond issue, such as call options.

[175] Australian Energy Regulator, *Final decision: Victorian electricity distribution network service providers distribution determination 2011–2015*, October 2010, pp495-496

270. Alternatively, if the Commission is disinclined to rely on these Telstra-wide estimates, a second-best alternative would be to continue to rely on the extrapolated Bloomberg fair value. There is no clear reason why this approach should suddenly be abandoned by the Commission in favour of reliance on a single bond yield.

271. As set out in Telstra's submission to the 2010 Draft Report[176] and in Telstra's response to the Commission's request for further information[177], a reasonable range for the Telstra-wide DRP is 2.36% to 4.56%, which is in line with the Commission's estimate in the 2010 Draft Report (based on Bloomberg fair value estimates) of 3.06%. Accordingly, Telstra submits that a reasonable estimate for the DRP is 3.06%.

2.1.3. GAMMA[178]

272. In the Discussion Paper the Commission proposes to adopt an economy-wide value for gamma of 0.45. However the Commission also recognises that there is some uncertainty around the value for gamma and seeks submissions on the appropriate value.[179]

273. Telstra agrees that an economy-wide value for gamma is appropriate and provides stronger incentives to operate efficiently. While Telstra has argued for a company-specific approach to the distribution rate in the past, it is noted that there is now greater certainty and reliability around the economy-wide value for both the distribution rate and theta.[180]

274. Telstra submits that in light of recent evidence, an economy-wide value of 0.45 can no longer be supported. The Australian Competition Tribunal has recently decided that the correct value for gamma is 0.25 in its merits review of the AER's electricity distribution determinations for Queensland and South Australia.[181] The Tribunal found that the correct distribution rate is 0.7, based on evidence of the historical economy-wide credit payout ratio, which the AER conceded could not support a distribution rate above this value. The Tribunal determined a value for theta of 0.35, based on a recently commissioned state-of-the-art dividend drop-off study.[182]

275. Accordingly, Telstra submits that the Commission should adopt a value for gamma of 0.25, in line with the Tribunal decision.

2.1.4. ALLOWED RETURN ON CAPITAL DOES NOT REFLECT A PROPER CONSIDERATION OF THE EVIDENCE OR RELEVANT CONSIDERATIONS

276. Telstra has a legitimate business interest in recovering the value of its investments and achieving a reasonable commercial return on this value. Providing for a reasonable rate of return is also critical to future investment in telecommunications infrastructure. Accordingly, Telstra submits that the legislative criteria dictate that the Commission must update its WACC parameters to reflect the level of commercial risk now faced by Telstra.

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[176] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, pp 83-84

[177] Telstra, *Pricing principles for fixed line services: response to the ACCC's request for further information*, November 2010, pp 25-28

[178] Telstra notes that under a post-tax framework, gamma does not directly impact the rate of return (rather, it impacts the separate tax building block). However for convenience, gamma is dealt with in this section along with other rate of return parameters.

[179] Discussion Paper, p 103

[180] In any event, as noted in the Telstra submission to the Draft Report, the Telstra-specific distribution rate is only slightly higher than the long-term average across all companies (0.9 compared to 0.7). Therefore the decision as to whether a company-specific or economy-wide distribution rate is chosen does not significantly affect the overall estimate of gamma.

[181] *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9

[182] SFG Consulting *Dividend drop off estimate of theta*, Final Report, *Re Application by Energex Limited (No 2) 2010 ACompT 7*, 21 March 2011.

2.2. Tax expenses should be calculated on the basis of tax asset values not accounting asset values

Key points:

Tax expenses are calculated on the basis of accounting asset values which significantly underestimates Telstra's actual tax expenses. It should be calculated on tax asset values.

277. In the Discussion Paper, the Commission states that:

    (a) it would be in the Access Provider's legitimate business interests to seek to recover its costs as well as a normal commercial return on investment having regard to the relevant risk involved,[183] and

    (b) Telstra's RAF data represented the most complete and accurate account of the historic cost of the fixed line network.[184]

278. In the Discussion Paper the Commission calculates corporate income tax expenses on the basis of the accounting value of the relevant assets.[185] However, Telstra's actual corporate income tax expenses are based on the tax value of assets. The tax value of Telstra's network assets included in the Commission's FLSM are, on average, [c-i-c commences] [c-i-c] [c-i-c ends] than the value of Telstra's network assets as reflected in the Commission's FLSM.

279. Telstra has provided the Commission with details of the tax value of Telstra's assets by way of confidential letter dated 26 May 2011. Telstra refers to, and relies upon, the information contained in that letter.

280. The reason for the difference between the tax value of Telstra's network assets and the value of those assets as recorded in Telstra's RAF data is because the Australian Taxation Office permits firms (including Telstra) to accelerate depreciation for tax purposes at faster rates than they might depreciate their assets in their accounts. In early years of an asset's life, firms can reduce their tax expenses by accelerating tax depreciation, because this allows the firm to deduct more tax depreciation from their taxable income than would otherwise be the case without accelerated tax depreciation. However, if tax depreciation was accelerated, then in later years of the asset's life there would be less tax depreciation to deduct from income, so tax expenses will be higher.

281. Telstra has accelerated its tax depreciation to lower its tax expenses. Hence, Telstra's tax value of assets is lower than its accounting value of assets. To reflect actual tax costs in a post-tax model such as the FLSM, the Commission should use Telstra's tax value of assets rather than the accounting value of assets. It its letter of 26 May 2011, Telstra sets out the steps that would need to be taken by the Commission to appropriately reflect diminishing value tax depreciation for existing assets. Where these adjustments are made, the tax expenses calculated in the FLSM will closely approximate Telstra's actual tax expenses relating to the same assets covered by the FLSM.

282. In the Discussion Paper, the Commission notes the statement of the Australian Energy Market Commission (**AEMC**) that: "the difference in approaches to valuing initial tax assets would in most cases not lead to a difference in the estimated cost of corporate income

[183] Discussion Paper, p 18.

[184] Discussion Paper, p 45.

[185] Discussion Paper, p 120.

tax".[186] In the Discussion Paper the Commission indicates that on the basis of the AEMC's statement the Commission proposes to adopt the "standard regulatory approach" of setting the initial tax asset value equal to the regulatory asset value.[187] The Commission goes on to note that such an approach has been adopted in the AER's PTRM, by the Victorian Essential Services Commission (**ESCV**) and by the AEMC in its 2006 Rule Determination.

283. In relation to the AER's PTRM, Telstra does not consider that the AER's PRTM adopts an approach which sets the initial tax asset value equal to the regulatory asset value. This includes because:

    (a) the AER's PTRM provides for different cells into which the regulatory asset value and the tax asset value are inserted;[188]

    (b) the AER's PTRM handbook notes that the opening RAB and the opening tax asset base are used for different purposes (that the opening RAB is the value of assets on which a return will be earned, and the opening tax base to calculate depreciation for tax purposes), and that the RAB and tax asset base will differ each year to reflect forecast capital expenditure (as-incurred for the RAB or as-commissioned for the tax asset base), asset disposals and regulatory depreciation (for the RAB) or tax depreciation (for the tax asset base);[189] and

    (c) the sample input sheet in the AER's PTRM handbook suggests that there is nothing unusual about there being a significant difference between the opening RAB and the opening tax asset base, with the sample input sheet recording a RAB of $4,369.79 million and an opening tax asset base of $2,992.33 million.[190]

284. It is common practice for the AER to adopt very different values for the RAB and the tax asset base in its electricity transmission and distribution determinations. In the recent distribution determination applying to ETSA Utilities in South Australia, the value for the RAB was $2.77 billion, while the tax asset base was $1.1 billion.[191]

285. In the AER's specific guidance for calculating the open taxation asset value for firms transitioning to a post-tax regime, the AER states the following:

    - *Careful attention is required to ensure appropriate initial asset values for tax purposes are set (the tax base). The tax base should, where possible take into account the actual tax position of assets that constitute the RAB.*
        - *The tax base can be established with the following information:*
            - *The date the business was first subject to tax (or the national tax equivalence regime (NTER))*
            - *The tax value of assets at that date, in sufficient detail to distinguish RAB assets from any non-RAB assets*

[186] Discussion Paper, p 120 referring to: AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, p. 90.

[187] Discussion Paper, p 120.

[188] See for example: AER, *Final Decision – Amended Transmission Post-Tax Revenue Model*, December 2010, Appendix A (Transmission Post-Tax Revenue Model), Inputs and Assets sheets.

[189] AER, *Electricity Transmission Network Service Providers Post-Tax Revenue Model Handbook: Amendment*, December 2010, p 4.

[190] AER, *Electricity Transmission Network Service Providers Post-Tax Revenue Model Handbook: Amendment*, December 2010, p 3.

[191] AER, *South Australia Distribution Determination 2010-11 to 2014-15*, May 2010, pp 146, 248; ETSA Utilities, *Revised Regulatory Proposal 2010 – 2015*, 14 January 2010, p 209.

— *The vintage profile of the RAB assets when first subject to tax including any capex that took place prior to the commencement of regulation*

- *The tax base established when first subject to tax can be rolled forward to the commencement of the post-tax approach taking account of relevant tax depreciation provisions, actual capex and disposals.*

- *For government owned businesses, a similar approach should be adopted, utilising the transition to the NTER to establish the initial tax base (to be rolled forward to the commencement of post-tax regulation.*[192]

286. The principles stated by the AER above implies starting with the actual taxation value of the assets at a date when a robust figure is available, and then adjusting that figure thereafter for additions and depreciation according to the prevailing tax law at the time.

287. The calculation of the tax asset value undertaken by ETSA Utilities went one step further than the principles set out above – with the recalculation of its tax asset value undertaken on the basis of records of historical capital expenditure and the depreciation permitted under the prevailing tax law. ETSA Utilities' proposal was accepted by the AER with only minor changes.[193] ETSA Utilities described its method for deriving the initial tax asset base in some detail and summarised the approach as follows:

> *In this proposal, additions are taken to have been acquired and recognised in the tax asset base at cost and depreciated in accordance with ordinary tax rules prevailing from 1946 to the date of first regulation and ultimately through to 1 July 2010.*[194]

288. Jemena Gas Networks (NSW) adopted a similar approach to that of ETSA Utilities and this was also approved by the AER with only minor changes.[195]

289. Telstra also submits that the AEMC does not adopt an approach that sets the initial tax asset value equal to the regulatory asset value. In the AEMC's 2006 rule determination, the AEMC considered whether tax depreciation should be calculated on the basis of actual initial tax asset values as opposed to benchmark initial tax asset values.

290. In the AEMC's 2006 rule determination, the AEMC concluded that it would be appropriate to use a benchmark approach to determining the estimate of tax depreciation.[196] The AEMC did not adopt an approach of setting the initial tax asset value equal to the regulatory asset value. The AEMC's reference to "the difference in approaches to valuing initial tax assets would in most cases not lead to a difference in the estimated cost of corporate income tax" is a reference to the taking of an actual or benchmark approach to the determination of the initial tax asset value – not whether the tax asset value is set to a different value to that of the RAB.

291. That the AEMC adopts a benchmark approach is clear from clause 6A.6.4 of Chapter 6A of the National Electricity Rules, which provides that in determining the estimated cost of corporate income tax the estimate:

> *…must take into account the estimated depreciation for that* regulatory year *for* tax *purposes, for a benchmark efficient* Transmission Network Service Provider*, of assets*

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[192] AER, *Matters Relevant to Distribution Determinations for ACT and NSW DNSPs for 2009 – 2014: Preliminary Positions*, November 2007, pp 51 – 52.

[193] AER, *South Australian Distribution Determination 2010-11 to 2014-15*, May 2010, pp 146 – 162.

[194] ETSA Utilities, *Revised Regulatory Proposal 2010 – 2015*, July 2009, p 258.

[195] Jemena Gas Networks (NSW), *Access Arrangement Information*, Appendix 9.3 (Effective Tax Rate), 26 August 2009, p 5; AER, *Jemena Gas Networks Access Arrangement Proposal for the NSW Gas Networks 1 July2 010 – 30 June 2015: Final Decision*, June 2010, p 206.

[196] AEMC, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18: Rule Determination*, 18 November 2006, p 90.

where the value of those assets is included in the regulatory asset base for the relevant transmission system *for that* regulatory year.

292. The reference to the "current regulatory practice" of the ESCV in the AEMC's 2006 rule determination appears to properly be to the practice of that regulatory body in using benchmark tax values[197], as opposed to setting the tax asset base equal to the RAB. In the 2006 Electricity Distribution Price Review undertaken by the ESCV, the ESCV:

    (a) calculated projected taxation liabilities using benchmark assumptions; and

    (b) carried over the opening tax value from the previous regulatory period (in which the Office of the Regulator General was the relevant regulator), and determined classes of assets for tax purposes and depreciation rates on the basis of professional tax advice.[198]

293. In the 2001 Electricity Distribution Price Review, which was the review prior to the 2006 review undertaken by the ESCV, the Office of the Regulator General (ORG) also adopted a benchmark approach to determining tax liabilities – based on a regulatory asset value, increased by actual capital expenditure and written down according to benchmark depreciation rates.[199]

294. In the 2003 Gas Access Arrangements Review, the ESCV adopted a similar benchmark approach to determining the tax asset value. The approach taken by the ESCV was to adopt the value permitted by the taxation law. The ORG (which was subsumed into the ESCV from 1 January 2002) position paper provided:

> *Regarding the third of these* [the opening value of the assets for taxation purposes] *the Office proposes that the benchmark tax calculation should adopt the value permitted by taxation law for establishing the opening value of assets for tax depreciation purposes. The Office notes that this value is prescribed in Division 58 of the* Income Tax Assessment Act 1997*. The essence of the division is to require the opening value of depreciable plant for an entity, which was previously exempt from tax, to be the 'undeducted pre-existing audited book value'. That is, the balance sheet value of depreciable plant in the annual unqualified audited accounts as at the end of the accounting period of the exempt entity, plus any additions between the balance sheet date and the date it ceases to be an exempt entity. Where the undeducted pre-existing audited book value of the asset is more than 12 months old, it must be adjusted for depreciation for the relevant period. In addition, the audited accounts must have been audited and signed off by a qualified independent auditor before 4 August 1997. Therefore, the audited accounts of 30 June 1996 are likely to provide the commencing value subject to any adjustments for new additions and depreciation.*[200]

295. In the ESCV 2003 Gas Access Arrangements Review final decision the ESCV explained its approach to the setting of the tax asset base as being one directed at reflecting an unbiased estimate of the taxation liabilities for an efficient company.[201] The ESCV's view was that an efficient company would seek to minimise its taxation liabilities, and if this could be achieved by adopting a method for depreciation that would yield the greatest tax deduction, the gas distributor would do this.[202]

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[197] AEMC, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18: Rule Determination*, 18 November 2006, p 90.

[198] ESCV, *Electricity Distribution Price Review 2006-10 Final Decision Volume 1 Statement of Purpose and Reasons*, October 2005, p 398.

[199] ORG, *2001 Electricity Distribution Price Review – Issues Paper*, February 2000, p 102; ORG, *Electricity Distribution Price Determination 2001-05 Volume 1 Statement of Purpose and Reasons*, September 2000, p 311 – 312.

[200] ORG, *2003 Review of Gas Access Arrangements: Position Paper*, September 2001, p 46.

[201] ESCV, *Review of Access Arrangements: Final Decision*, October 2002, p 388.

[202] ESCV, *Review of Access Arrangements: Final Decision*, October 2002, p 388.

296. It follows from the above that the regulatory practice of the ESCV (and the ORG before it) is to apply benchmark tax values in setting the tax asset value.

297. Telstra submits that it would be consistent with the matters that the Commission is required to take into account in making the FADs that relevant tax liabilities are calculated by reference to a tax asset value determined on the basis set out in Telstra's letter of 26 May 2011. An approach that sets the tax asset value equal to the value for the RAB proposed by the Commission would significantly underestimate Telstra's actual tax expenses. Such an approach will harm Telstra's legitimate business interests and not provide Telstra with an opportunity to recover the direct costs that it incurs in providing access to the declared services. Such an approach could not be considered to promote the long-term interests of end-users.

2.3. The Commission's direct operating expenditure forecasts appear reasonable

Key points:

The Commission's direct operating expenditure forecasts appear reasonable but it is difficult to determine the underlying drivers that the Commission has considered.

298. Telstra has examined the operating expenditure forecasts contained in the spreadsheet "F. Opex Allocations" sheet in the FLSM and consider that they are reasonable for the period covered in the model.

299. Although the Commission has not provided Telstra with any calculations underlying the forecasts, Telstra has undertaken an analysis of the drivers of operational expenditure for the CAN and IEN. While the relationship is complex, Telstra considers that the main drivers of CAN and IEN operational expenditure (excluding depreciation) include, but are not limited to, labour costs (both internal labour expenses and costs related to service contracts for outsourced technical workforce), productivity, and the level of reported faults. An increase in either of these drivers would be likely to lead to an increase in operational expenditure.

300. Telstra notes that labour costs in Australia have been increasing for some time, but may be partially offset by productivity measures in coming years. ABS labour indices show that wages in the Information Media and Telecommunications sector[203] have increased by more than 32% in the five years to February 2011, at an average of 6.6% per year. Additionally, Telstra's service contracts for the outsourced portion of its technical workforce were renegotiated during 2010, and included an average [c-i-c commences] [c-i-c] [c-i-c ends] increase in the schedule of charges which Telstra must pay for network maintenance.

301. The volume of faults in the CAN has also been increasing over the past four years at an average of [c-i-c commences] [c-i-c] [c-i-c ends] per year.

302. These drivers indicate that operational expenditure may grow at a faster rate than CPI (Telstra notes that average annual growth rate for CPI is approximately 3%).[204] Telstra notes that the Commission has applied a low upward trend over the regulatory period. That said, Telstra recognises the difficulty in converting rates of change in drivers to rates of change in operational expenditure. As stated above, that relationship is complex.

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[203] ABS, *Cat No: 6302.0 Average Weekly Earnings, Australia*, see Table 10G. Average Weekly Earnings, Industry, Australia (Dollars) - Original - Persons, Full Time Adult Ordinary Time Earnings A2751723F: Earnings; Persons; Full Time; Adult; Ordinary time earnings ; Information Media and Telecommunications, latest release February 2011.

[204] ABS, *Cat No: 6401.0 Consumer Price Index, Australia*, latest release March 2011.

303. Given this complexity, if the Commission is minded to reconsider its operational expenditure forecasts, Telstra considers it is important that is has the opportunity to submit material in relation to those proposed changes.

2.4. There are several other issues with the FLSM

Key points:

There are several computational errors in the FLSM, which require correction.

304. Aside from the issues raised above, Telstra notes that there are a number of additional errors in the FLSM which need to be addressed by the Commission. In particular:

(a) The total CORE revenue requirement in table E.1.2 includes items CO01 to CO07. This total is used as the denominator in the calculation of some allocators, however the numerator of those calculations includes only items CO01 to CO06.

(b) Land, buildings and support are allocated between CAN and CORE in a way that is not transparent. The result is that a large proportion of these costs are allocated to CORE, while only 9% of land and 15% of buildings and support are allocated to CAN. This allocation between CAN and CORE is significant, in light of the way in which costs are allocated for CAN and CORE services - fewer costs allocated to CORE are actually allowed to be recovered as a result of the Commission's assumptions around demand (refer to section 1.2 above). Telstra considers that a 50% allocation of land, buildings and support to the CAN is more appropriate.

305. Telstra submits that these issues in the Commission's FLSM should be addressed prior to making the FADs. These issues materially affect Telstra's ability to recover the costs of supplying the fixed line services and achieve a commercial return.

306. These issues aside, Telstra assumes that the Commission is satisfied that the FLSM otherwise contains correct inputs and calculations. However, if the Commission considers that the inputs or calculations should be changed, Telstra requests an opportunity to make submissions in relation to those proposed changes.

3. COSTS ARE NOT PROPERLY CONVERTED INTO PRICES

3.1. There is no sound basis for a shift to a new, nationally averaged pricing structure for PSTN OTA

Key points:

There is clear justification for retaining the existing de-averaged price structure, which is corroborated by figures from the Commission's Analysys model.

By contrast, if a nationally averaged price is set, there can be no reasonable expectation of commercially negotiated de-averaging.

Nationally averaged pricing would be harmful, including because prices would not reflect costs, and costs would be under-recovered due to skewed usage patterns.

307. Telstra supports the notion that OTA prices should be retained at the same level (ie at a 1c per minute headline rate) subject to adjustments in the structure to remove the access deficit contribution (**ADC**) and to reflect the current traffic distribution and call duration. However, Telstra is concerned that the Commission's support for this view about the level of prices – reflected in the unchanged "headline" rate of 1c per minute –is undermined by the proposed change to the structure of it.

308. In the Discussion Paper, the Commission considered two options for PSTN OTA:

- an update of the existing pricing structure by removing the ADC and using the current geographic traffic pattern and average call duration (option 1); and
- changing the price structure by setting a nationally averaged rate (option 2).[205]

309. While the Discussion Paper sets out arguments for and against each option, the Commission ultimately chose option 2 as its preferred position. However, the Commission does not provide adequate reasoning in its Discussion Paper as to why option 2 was preferred to option 1.[206] Elsewhere in the Discussion Paper, in the context of determining an initial RAB value, the Commission notes that it was important to protect the legitimate business interests of both Access Seekers and Telstra. This consideration was what led the Commission to conclude that "a clear justification is required for any significant change in existing prices".[207]

310. Telstra submits that the Commission has not given any clear justification for the proposed change in the structure of PSTN OTA prices, which does result in a significant change in existing prices. The cost relativities currently applied have been previously accepted by the Commission as sufficiently reliable, and consistent with the legislative criteria. The Discussion Paper does not set out sufficient evidence or the Commission's reasoning as to why a change to a new pricing structure would promote the legislative criteria to any greater extent than the present structure.

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[205] ACCC, Discussion Paper, p. 148.

[206] See the ACCC Conclusion section on page 150 of the Discussion Paper – the ACCC merely states that 'In setting PSTN OTA charges in the FADs, the ACCC proposes to set a national average PSTN OTA price (option 2) for the proposed five-year regulatory period'.

[207] ACCC, Discussion Paper, p. 47.

311. On the contrary, evidence before the Commission shows that there is a clear justification for retaining the existing price structure. In particular, Telstra provided detailed information which showed that the distribution of traffic by geographic area and the average call duration have not changed significantly since 2003.[208] Further, Telstra, Macquarie Telecom and AAPT in submissions to the Commission's 2010 Draft Report all cited the fact that the current structure of prices reflected the underlying costs of providing services.[209] In particular, Telstra indicated that the current structure reflects the underlying costs on two dimensions – it mirrors the fixed and variable cost split (captured in two-part pricing[210]) and it reflects the cost differences in different geographic areas.

312. In response to the Commission's concerns about the reliability of information regarding geographic cost relativities, Telstra provides further information in this section to give the Commission confidence that the relativities used are reasonable and reliable.

313. The remainder of this section is structured as follows:

    (a) first, there is an outline why de-averaged pricing should be maintained, including by showing that the cost relativities that the Commission has used reflect Telstra's cost structures and the cost relativities in the Analysys model;

    (b) second, there is an explanation the impact on commercial negotiations of setting an average price;

    (c) third, there is an elaboration on specific harmful impacts that would result from setting a nationally averaged price; and

    (d) finally there is a discussion on the importance of these issues under the legislative criteria.

3.1.1. THE EXISTING GEOGRAPHICALLY DE-AVERAGED PSTN OTA PRICING STRUCTURE REFLECTS COST RELATIVITIES AND SHOULD BE RETAINED

314. The Commission's main concern with option 1 – updating the existing price structure by removing the ADC and using the current geographic traffic pattern and average call duration – appears to be a lack of confidence in the methodology used to set the existing pricing matrix (the adjustments are made sequentially in Tables 11.5–11.7).

315. According to the Commission, updating the pricing matrix in Table 11.7 would set charges that more accurately reflect costs and current calling patterns.[211] The Commission also states that the prices more closely reflect actual call conveyance costs and cost relativities across the four geographic areas obtained from the PIE II model. However, the Commission was concerned that it did not have current "updated cost information to verify that the costs estimated from the PIE II model are an accurate reflection of current actual costs".[212]

316. At the outset, it should be acknowledged that there are significant geographic cost differences involved in supplying PSTN OTA. As explained in Telstra's 9 October 2009

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[208] Telstra, *Submission to the ACCC's Draft Report – Review of the 1997 telecommunications access pricing principles for fixed line services,* September 2010, p. 127 and p. 129.

[209] Telstra, *Submission to the ACCC's Draft Report – Review of the 1997 telecommunications access pricing principles for fixed line services,* November 2010, pp. 125–129; Macquarie Telecom, *Submission to the ACCC's Draft Report – Review of the 1997 telecommunications access pricing principles for fixed line services,* 22 October 2010, p. 2; and AAPT, *Submission to the ACCC's Draft Report – Review of the 1997 telecommunications access pricing principles for fixed line services,* October 2010, pp. 4–5.

[210] Telstra agrees that two-part pricing is appropriate for PSTN OTA, for reasons set out in its *Response to the ACCC's draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS* dated 9 October 2009, at section F.2.

[211] Discussion Paper, p. 149.

[212] Discussion Paper, p. 149.

submission Response to the ACCC's draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS, these costs vary between urban and regional/rural areas for a number of reasons:

(a) Switching costs increase with the number of exchanges included in a route and the costs of switching equipment. The majority of call charge areas (**CCAs**) are made up of rural/remote exchanges only. PSTN OTA calls originating or terminating in regional-only CCAs will be required to pass through a greater number of switching stages to reach the point of interconnection – with the consequent increase in costs.[213]

(b) Transmission costs are a major driver of OTA costs, and lead to higher costs in rural/remote areas. Transmission costs comprise trenching costs, and transmission equipment costs. Distance between customers and exchanges (line lengths) are the most significant factor influencing transmission costs. There are large differences in population and density across Australia, requiring longer line lengths in rural areas than urban areas, resulting in higher costs.[214]

(c) Demand levels are lower in rural/remote areas, and traffic demand is in effect, the cost denominator.[215]

(d) Network design in rural/remote areas must reflect the additional cost of technical requirements that arise due the greater distances involved e.g. the use of synchronous digital hierarchy (**SDH**) rings to provide network integrity.[216]

317. The reality of these cost differences, especially in a country like Australia where the transmission distances are comparatively large, must be taken into account. Telstra notes that the Discussion Paper includes a comparison of price structures across NZ, Europe and the US, showing that only a few countries have geographically de-averaged prices. Telstra submits that the Commission's conclusion that de-averaging is uncommon in these countries is of no probative value in the present case. Australia is far larger and less dense than most of the countries in that comparison, exacerbating the cost differences. Moreover, there is no consideration of why some countries do not de-average prices; or whether, as a policy matter, it is preferable to the extent that it can be achieved. The mere fact that some countries do not de-average does not of itself shed any light upon the merits of de-averaging either in those countries or under the relevant legislative criteria in Australia

318. Telstra reviewed the Commission's methodology as set out in Table 11.7. This review involved considering whether the cost relativities underlying the Commission's current price matrix were reasonable in relation to the cost relativities that the Analysys model applies as well as Telstra's cost structures. Following this review, Telstra considers that the Commission can have confidence in the cost information and the methodology it has adopted. In particular, the Commission can have confidence that the prices calculated in Table 11.7 appropriately reflect cost relativities in the four geographic bands as the relativities are similar to the relativities in the Commission's Analysys model.

319. Given this, Telstra submits that the Commission should adopt option 1, not option 2, in setting PSTN OTA prices in the FAD.

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[213] See Telstra's *Response to the ACCC's draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS* dated 9 October 2009, at par 69, and documents referenced therein, including: Synergies Economic Consulting, *PSTN OTA Benchmarking study*, October 2009

[214] Ibid.

[215] Ibid.

[216] Ibid.

3.1.1.1.1. COST RELATIVITIES FROM THE ANALYSYS MODEL

320. Telstra derived the cost relativities from the Analysys model and used those to calculate PSTN OTA prices. The computations are summarised in Table 8. A detailed explanation of the methodology used to derive the cost relativities from the Analysys model is at Schedule A.7.

Table 8: PSTN OTA price matrix – based on Analysys model

Parameter	CBD	Metro	Provincial	Rural	Average
Total Traffic Distribution	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	
Total Cost Distribution	1%	27%	10%	62%	
Total Cost Relativities (Rural=1)	0.01	0.43	0.16	1.00	
Average Cost Relativities (Rural=1)	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	
Average Cost (cpm)	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	1.00
Flagfall (cents per EMOU)	0.04	0.09	0.20	1.62	0.25
Flagfall (cents per call)	0.10	0.24	0.51	4.25	0.66
Conveyance (cents per EMOU)	0.11	0.28	0.59	4.87	0.75
Headline Rate (cents per EMOU)	0.15	0.37	0.78	6.49	1.00

321. As shown in Table 8 above, the cost relativities from the Analysys model result in prices per geographic band that are broadly similar to the Commission's calculations in Table 11.7.

3.1.1.1.2. TELSTRA'S COSTS IN THE COMMISSION'S PRICING MATRIX

322. The Commission has indicated that it is not confident in the prices in Table 11.7 of the Discussion Paper. In order to test the robustness of those prices Telstra has reconstructed the Commission's pricing matrix in Table 11.7 using a simpler method, and has entered its current cost information. A description of Telstra's methodology is in Schedule A.7. Telstra's price matrix is shown in Table 9 below.

Table 9: PSTN OTA price matrix – recalculated from Commission's Table 11.7

Parameter	CBD	Metro	Provincial	Rural	Average
Total Traffic Distribution	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	
Total Cost Distribution	2%	38%	11%	49%	
Total Cost Relativities (Rural=1)	0.04	0.78	0.22	1.00	
Average Cost Relativities (Rural=1)	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	
Average Cost (cpm)	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	[c-i-c commences] [c-i-c] [c-i-c ends]	1.00
Flagfall (cents per EMOU)	0.10	0.13	0.21	1.28	0.25
Flagfall (cents per call)	0.26	0.35	0.54	3.34	0.66
Conveyance (cents per EMOU)	0.30	0.40	0.62	3.83	0.75
Headline Rate (cents per EMOU)	0.40	0.53	0.83	5.10	1.00

323. As shown in Table 9 above, the resulting headline rates from using Telstra's updated cost information (and a different, simpler methodology) are almost identical to the Commission's calculations in Table 11.7.

3.1.1.1.3. WHAT PRICES SHOULD THE COMMISSION ADOPT?

324. The above analysis demonstrates that the cost relativities derived from the PIE II model are broadly similar to the cost relativities from the Analysys model across the four bands (see Table 10).

Table 10: Cost relativities across models

Cost relativities	CBD	Metro	Provincial	Rural
Analysys model	1%	27%	10%	62%
Adjusted Table 11.7 (based on PIE II model)	2%	38%	11%	49%

325. As the two models produce similar cost relativities to those reflected in Table 11.7 (and in light of the other evidence before the Commission of the appropriateness of the existing cost relativities, and the lack of any clear justification to change that approach) Telstra submits that the Commission should be confident that the prices in Table 11.7 are appropriate to apply.

3.1.2. IF A NATIONALLY AVERAGED PSTN OTA RATE IS SET, THERE CAN BE NO EXPECTATION OF COMMERCIALLY NEGOTIATED DE-AVERAGING

326. Telstra understands from the Discussion Paper that the Commission intends to set a nationally averaged PSTN OTA price, while enabling Access Seekers to commercially

negotiate de-averaged prices, if they wish, on the basis of additional information (the type of which is open to consultation) that would be provided by the Commission on relative geographic costs.

327. If that understanding is correct, then Telstra submits that the Commission would be wrong to expect that, under the proposed option 2 where a nationally averaged price is set, geographically disaggregated prices can be negotiated. This simply would not occur.

328. No Access Seeker would have an incentive to agree to pay prices which, on average, are higher than the nationally averaged price set by the Commission. At the same time, all Access Seekers would object to paying higher (nationally averaged) prices in regions where they currently pay a lower price. Correspondingly, Telstra would have no incentive to agree to prices that are, on average, lower than the nationally averaged price set by the Commission (particularly as this price is already lower than the average price presently paid, as explained below).

329. There is therefore no likelihood of agreement on disaggregated prices once a nationally averaged price has been set by the Commission. The pursuit of disaggregated prices in the face of a set average price – with or without the further information that the Commission proposes be made available – is likely to lead only to disputation.

3.1.3. A NATIONALLY AVERAGED PSTN OTA RATE WOULD ALSO HAVE ADVERSE IMPACTS ON THE LTIE AND UNDER OTHER FAD CRITERIA

330. Not only is there no basis for a shift in pricing structure for PSTN OTA, but the adoption of nationally averaged rates would have a number of adverse impacts on the LTIE.

331. First, nationally averaged prices would fail to reflect the differences in costs incurred in providing services in different geographic areas, which the Commission itself acknowledges is a desirable outcome. Prices that fail to reflect costs would send incorrect price signals to Access Seekers about the costs of PSTN OA and TA, and give rise to an inherent cross-subsidy between lower cost metro callers and higher cost regional/rural users (who typically have longer transit links), because all OTA minutes would be charged at the same rate regardless of these underlying cost differences.

332. Second, averaged pricing would lead to an immediate fall in OTA revenues and cost under-recovery by Telstra, resulting in a shortfall in the revenue requirement. Presently, as a result of PSTN OTA usage that is geographically skewed, the current average price paid by wholesale customers is in fact higher than the "headline" rate of 1 cent per minute. This is because wholesale customers have bypassed Telstra's OA services more in densely populated areas[217], while using Telstra's TA services to reach rural areas. The average price paid under the current de-averaged model is in fact around 1.3 cents per minute, above the headline rate of 1 cent per minute.

333. If Telstra were to be required to provide the same OTA minutes at a nationally averaged price of 1 cent per minute, its OTA revenue would obviously fall. Telstra would then have two options in the face of averaged OTA prices:

- recover more of its costs from its retail customers (ie, subsidise Access Seekers from its retail customers); or
- face a revenue shortfall.

[217] OTA bypass can occur through alternative networks (e.g. Optus HFC) or ULLS. For example, if an access seeker believes that OTA is too expensive, they could instead use ULLS to service that customer. These alternative networks exist mostly in metropolitan areas.

334. Telstra cannot simply raise its retail charges to cover the revenue shortfall. It faces retail competition and competitive constraints that would be likely to make it impossible to recover costs by this means. Moreover, Telstra is still subject to retail price cap constraints.[218]

335. This cost under-recovery would likely be exacerbated over time, because under ULLS-based competition, or as the NBN rolls out, or in the transition from one to the other, the likely outcome will be even greater bypass of Telstra's metropolitan than regional networks by competitors who can acquire terminating access in rural areas at (averaged) prices that are below cost. In light of the incorrect price signals discussed above, such distortions would be even more likely to occur.

336. There would also be consequences for retail prices, which would undermine Telstra's ability to recover costs. As rural originating access prices are reduced to nationally average levels, the corresponding long distance retail prices are also likely to fall and Telstra would be required to reduce its retail prices, further eroding its ability to recover costs or to cross-subsidise Access Seekers (with the associated harm to competitive neutrality). The result would be a windfall gain for Access Seekers, and impacts on Telstra that would not be consistent with its legitimate business interests.

3.1.4. THE AVERAGING OF THE PSTN OTA DOES NOT REFLECT A PROPER CONSIDERATION OF THE EVIDENCE OR RELEVANT CONSIDERATIONS

337. In arriving at the view that option 2 should be adopted, the Commission has not given proper consideration to the evidence or relevant considerations under the legislative criteria.

338. As outlined above, there is significant evidence before the Commission that the present de-averaged pricing structure is justified, including additional material provided by Telstra in this submission.

339. Option 2 represents a significant change in the PSTN OTA price level and structure. The Commission has given no adequate reasoning for this change.

340. This change will leave a revenue shortfall because of the geographic pattern of consumption. This shortfall will not be able to be made up by other means. Compared with the present, de-averaged price structure, the proposed prices will be less aligned with costs, and will lead to revenue shortfalls and disputation. This would fail the criteria to be considered when making an FAD, including because:

- it fails to meet Telstra's legitimate business interest in the pricing of services to enable recoupment of costs and avoiding revenue shortfalls under the RAB methodology; and
- it would not be in the LTIE, or be economically efficient, to give incorrect price signals, to promote distorted consumption patterns, or to harm competitive neutrality.

341. Telstra submits that the Commission should revert to de-averaged prices consistent with option 1 and historical practice. Telstra has reviewed the existing cost relativities underlying the pricing matrix in Table 11.7 against the cost relativities derived from the Analysys model. It has also considered Telstra's actual cost information using a simpler methodology. The results of this review show that there is no reason why the Commission should not have confidence in its methodology and should therefore adopt the prices for PSTN OTA as shown in Table 11.7.

[218] While changes have been proposed to 'basket 1' – the basket of local, trunk (including national long distance and FTM) and international calls and line rental – a price cap will continue to apply. The basket will be subject to a real price freeze (ie CPI - 0). See, ACCC, *Review of Telstra's price control arrangements – an ACCC report,* Public, March 2010, p. 11.

3.2. WLR prices are averaged incorrectly

Key point:

The average WLR price is weighted by WLR lines only, not by all lines. This will result in a price that is lower than the average cost of lines.

342. The Commission's model calculates the average WLR price by calculating the average unit costs of WLR in Bands 1, 2, 3 and 4, weighted by the WLR demand in each band.[219] However, the weights for the averaging should be based on total demand in each band (WLR, ULLS and Residual), as is done in the calculation of weighted average ULLS prices.[220]

343. The reason for this is because WLR demand is more heavily loaded toward Bands 1 and 2 relative to total lines.[221] Thus, the average WLR price weighted by WLR demand ($22.47) will be less than the average cost of lines over all SIOs calculated by the FLSM ($23.34). The weighting of WLR average prices by WLR demand, not total demand, has at least three consequences that are inconsistent with the legislative criteria.

344. First, WLR Access Seekers will face a nationally averaged WLR price that is less than the nationally averaged cost of providing the lines and, therefore, less than the average costs allocated to Residual lines (which is predominately made up of Telstra retail lines).[222] This is inconsistent with the promotion of competition, since Access Seekers would be placed at a competitive advantage to Telstra.

345. Second, because WLR prices will be fixed until 2015/16 using WLR demand weights fixed at 2009/10, WLR Access Seekers will face the lower WLR price but then be able to increase their proportion of sales in Band 3 and 4 areas at that lower price. This is inconsistent with the encouragement of efficient investment by both WLR Access Seekers and Telstra. WLR Access Seekers will face a low price to supply WLR in Band 3 and 4 areas relative to average cost, and will be encouraged to inefficiently increase their investment in the supply of WLR in those areas. Telstra will be required to inefficiently invest in infrastructure to cater for this additional demand in those areas.

346. Third, Telstra's retail line rental prices will be constrained by competition from WLR Access Seekers. Thus, if Telstra is prevented from recovering the higher costs allocated to retail line rental than WLR, then Telstra will not recover its costs. This will be inconsistent with Telstra's legitimate business interests and prevent the recovery of Telstra's direct costs.

[219] Table D.6.3, row 198.

[220] Table D.6.2, row 183.

[221] Table D.1.1.

[222] This is shown in the FLSM by comparing the average duct and pipes cost for WLR lines (Table D.3.4, row 88) with the average duct and pipes cost for Residual lines (Table D.3.5, row 97). The later is 9-11% higher than the former from 2009/10 to 2015/16.

4. THE REGULATORY IMPLEMENTATION INSTRUMENTS HAVE A NUMBER OF DEFICIENCIES

Key points:

The fixed principles provisions as proposed in the Discussion Paper do not currently achieve the stated aim of providing regulatory certainty and pricing stability.

As currently drafted, the fixed principles provide too much flexibility for inputs or methodologies to be changed within and between future regulatory periods. This creates uncertainty as to the future regulatory approach and gives rise to a risk that cost recovery may be jeopardised in the future as a result of changes in methodologies or inputs.

Telstra has proposed the minimum number of amendments that it considers would assist in providing regulatory certainty and reducing potential future areas of disputation, particularly regarding the roll-forward of the RAB between regulatory periods, the determination of the WACC, and the calculation of the annual revenue requirement (refer to Schedule 8).

The FADs should provide that prices are exclusive of taxes and that the Access Provider is entitled to charge a reasonable amount in addition to the specified prices to recover any tax liability where that liability is not accounted for or otherwise represented in the prices.

It is inappropriate for the Commission to consider issuing a Record Keeping Rule to require Telstra to provide information to the Commission on expenditure and demand forecasts for future regulatory periods and the Commission has not adequately justified its position on this issue.

4.1. The fixed principles should be used as a mechanism to maximise certainty

347. The Commission states in the Discussion Paper that a key objective of its fixed principles is to promote regulatory certainty and provide for price stability.[223]

348. Telstra agrees that this should be a central objective of the fixed principles provisions, and indeed of the regulatory regime more generally. However, in their current form the fixed principles provisions do not provide adequate certainty as to how prices will be determined in future periods. Telstra submits that the fixed principles need to be significantly strengthened in order to provide certainty for all industry participants.

349. As currently drafted, the fixed principles provide too much flexibility for methodologies and inputs to be changed in future periods. This creates uncertainty and raises the risk that recovery of future costs may be jeopardised. For example, there is nothing in the fixed principles (as drafted by the Commission) that would require the Commission to maintain its current practice of calculating the annual revenue requirement in real terms and converting this to a nominal price. In the absence of any codification of this practice, there is a risk that the approach to price-setting may be changed in future periods in a way that puts at risk

[223] Discussion Paper, p 252.

cost recovery. Clearly this is a material risk, as in establishing the initial asset base, the Commission is proposing to move from an asset valuation that takes asset inflation into account to one that doesn't.

350. The proposed fixed principles provisions fail to offer certainty in a number of important respects:

    (a) The fixed principles provisions do not set out how the RAB value and other key inputs will be "updated" between periods, even though the Commission indicates in the Discussion Paper that this will be done;

    (b) The fixed principles provisions do not provide any detail on how the return on capital will be determined, other than to say that it will apply a real vanilla WACC. The fixed principles provisions could potentially offer greater certainty as to how particular parameters will be determined in future; and

    (c) The fixed principles provisions do not set out how the annual revenue requirement is to be determined for each year.

351. The Commission's approach on a number of these matters is evident from the FLSM. However, in order to provide certainty as to how these matters will be treated in future periods, this should be specified in the fixed principles provisions.

352. Telstra has previously provided a comprehensive working proposal, including detailed treatment of these and other matters.[224] It is not clear why the Commission has not adopted some of Telstra's more detailed provisions as part of its fixed principles.

353. If the Commission is not minded to adopt some of Telstra's more detailed provisions included in its draft working proposal, it should at least include more detail in its fixed principles provisions in order to provide greater certainty. Telstra has proposed a number of amendments to the Commission's fixed principles in Schedule A.8.

4.1.1. FIXED PRINCIPLES PROVISIONS SHOULD TERMINATE ON 30 JUNE 2021

354. Telstra submits that the termination date for the fixed principles provisions should be 30 June 2021, consistent with the termination date in the Discussion Paper.[225] This period should cover two regulatory periods of five years. A shorter period for the operation of the fixed principles provisions would not provide the regulatory certainty and price stability that is sought to be achieved by the fixed principles provisions.

355. To the extent that the Commission considers that regulatory periods of less than five years should be adopted, then only those inputs that are measurable and expected to change should be updated between shorter regulatory periods, (for example demand, opex and capex), consistent with Telstra's previous working proposal discussed with the Commission.[226] Other variables should remain fixed (for example, the initial asset base, depreciation methodology, WACC parameters). Allowing these variables to change on a shorter basis will result in greater disputation, and regulatory uncertainty. Further, the fixed principles should still span a period of 10 years, otherwise the objective of regulatory certainty and pricing stability is less likely to be achieved.

[224] Schedule 5 to Telstra's response to the Draft Report.

[225] Discussion Paper, Appendix C, p 6.

[226] Schedule 5 to Telstra's response to the September 2010 Draft Report

4.1.2. THE INITIAL VALUE OF THE RAB SHOULD BE STATED TO BE AT A PARTICULAR DATE AND DOLLARS

356. Clause 6.4 of the fixed principles provisions in the Discussion Paper provides that the initial opening RAB for the calculation of prices for the six declared fixed line services is $17.75 billion as at 1 July 2009.

357. As noted in paragraph 48, Telstra submits that the remaining value of its fixed line assets which could be used by the Commission to determine a value for the initial asset base should have been undertaken on the basis of both DAC and DORC, giving an initial asset base of approximately $31 billion. Telstra maintains that such a value should be adopted in the fixed principles provisions.

358. Telstra submits that whatever value the Commission determines as being the initial RAB, it is appropriate that this value is specified as part of a fixed principles provision. In order to avoid uncertainty in the future, the value should be specified as being at a particular date, and in specified dollars. That is, if the value of $17.75 billion is to be adopted by the Commission as the initial RAB the relevant clause should provide:

> *The initial opening regulatory asset base for the calculation of prices for the six declared fixed line services is $17.75 billion as at 1 July 2009 in July 2009 dollars.*

359. It is important to specify both:

(a) the point of time at which the initial RAB has been calculated as this indicates the point of time at which a determination was made as to the assets that comprised the RAB; and

(b) the dollars in which the value has been expressed as this is important in determining the opening value for the RAB in later regulatory periods, where it is necessary as part of the rolling forward of the value of the RAB to appropriately inflate that value.

360. As the Commission's approach is to specify the initial opening RAB as at 1 July 2009, it is also necessary to specify the method of calculating the opening RAB for the first regulatory period, commencing on 1 July 2011. Telstra has suggested some drafting in the fixed principle provisions to cater for this.

4.1.3. THE METHOD FOR CALCULATING THE OPENING RAB FOR THE SECOND AND SUBSEQUENT REGULATORY PERIODS MUST BE SPECIFIED

361. Clause 6.5 of the fixed principles provisions in the Discussion Paper provides for the roll-forward of the RAB from year-to-year within a regulatory period. Clause 6.5 does not explicitly provide for the roll-forward of the RAB from regulatory period to regulatory period. In order to achieve the desired outcome of regulatory certainty and stability of prices, Telstra submits that the fixed principles provisions should provide clearly for the establishment of the RAB as at the commencement of the second regulatory period (anticipated to be 1 July 2016) and subsequent regulatory periods.

362. This roll-forward should provide for the closing value of the RAB as at the conclusion of the immediately preceding regulatory period (which would include forecast capital expenditure and depreciation for that period[227]) to be increased by an amount necessary to maintain the real value of the RAB as at the beginning of the new base year for calculation of prices, by adjusting that value for compound inflation.

[227] Telstra notes that the within-period roll-forward would provide for forecast capital expenditure and depreciation for the previous period to be included in the closing value.

363. In relation to the treatment of inflation, Telstra notes that prices from the FLSM are based on capital values that have been indexed from 1 July 2009. This is demonstrated first with respect to the formula underlying prices in the FLSM. In general terms, the prices for any period t are derived by the FLSM using the following formula:

$$Price_t = \left(\frac{RR_t}{Demand_t}\right) \times (1 + CPI)^t$$

Where:

$Price_t$ – is the price of a service for time *t*
$Demand_t$ – is the demand of a service at time *t*
CPI – is the inflation rate
RR_t – is the revenue requirement for time *t*

The revenue requirement is determined using the following formula:

$$RR_t = r \times RAB_t + d \times RAB_t + OPEX_t + TAX_t$$

r – is the weighted average cost of capital
RAB_t – is the depreciated value of initial capital base and capex at time *t*, expressed in 2009 dollars
d – is the depreciation rate
$OPEX_t$ – is the forecast opex for time *t*
TAX_t – is the calculated tax for time *t*

Substituting the revenue requirement formula into the price formula yields the following equation.

$$Price_t = \frac{(r + d) \times RAB_t \times (1 + CPI)^t}{Demand_t} + \frac{(OPEX_t + TAX_t) \times (1 + CPI)^t}{Demand_t}$$

364. Therefore, insofar as prices are calculated by the FLSM, capital values are expressed in terms of the following indexed capital value at any period t.

$$RAB_t \times (1 + CPI)^t$$

365. Recognition that the FLSM model indexes asset values from 1 July 2009 is important, as it has an effect on the roll-forward of the asset base into the second regulatory period. The appropriate way to roll-forward those asset values, if capital expenditure, operating expenditure, inflation and other inputs are reset to a base year of 2016/17, is to take the closing value of the assets at 30 June 2016 and multiply them by the compounded inflation from the base year (1 July 2009) to the beginning of the next regulatory period 1 July 2016.

366. Explicit provision for the adjustment of the RAB to maintain its real value is an important aspect of regulatory certainty and price stability. It is a critical element of protecting the Access Provider's legitimate business interests and will also assist in ensuring that the direct costs of providing access to the declared services are taken into account.

4.1.4. THE METHOD FOR THE ROLL-FORWARD OF THE RAB BETWEEN YEARS IN A REGULATORY PERIOD SHOULD BE SPECIFIED

367. Telstra agrees that the method for the roll-forward of the RAB between years in a regulatory period should be specified. This is in effect what clause 6.5 of the fixed principles provisions in the Discussion Paper achieves.

4.1.5. ASSESSMENT OF FORECASTS FOR OPERATING AND CAPITAL EXPENDITURE SHOULD ALSO TAKE INTO ACCOUNT REGULATORY OBLIGATIONS OR REQUIREMENTS

368. Telstra submits that any assessment of forecasts for operating and capital expenditure should take into account regulatory obligations or requirements that are associated with the provision of fixed line services. Telstra has therefore inserted into the fixed principles provisions dealing with forecasts for operating and capital expenditure that in assessing the prudent and efficient operating and capital expenditure amounts for a regulatory period the Commission will take into account the applicable regulatory obligations or requirements associated with the provision of fixed line services. The term "regulatory obligation or requirement" would be defined as:

> *…an obligation or requirement under:*
> *(a) this access determination; or*
> *(b) an Act or instrument made or issued under or for the purposes of that Act, that levies or imposes a tax or other levy that is payable by the Access Provider; or*
> *(c) an Act or any instrument made or issued under or for the purposes of that Act, that regulates the use of land in a participating jurisdiction by the Access Provider; or*
> *(d) an Act of a participating jurisdiction, or any instrument made or issued under or for the purposes of that Act that relates to the protection of the environment; or*
> *(e) an Act, or any instrument made or issued under or for the purposes of that Act (other than an Act or instrument referred to in (a) to (d), that materially affects the provision, by the Access Provider, of the fixed line services.*

369. The inclusion of the requirement to have regard to applicable regulatory obligations or requirements in assessing forecast operating and capital expenditure amounts would be consistent with the National Electricity Rules applying to both electricity transmission and distribution networks.[228] The definition of the term "regulatory obligation or requirement" has been adapted from the definition of that term in the National Electricity Rules.[229]

4.1.6. NO ADJUSTMENT WHERE OUTTURN AMOUNTS ARE DIFFERENT TO FORECAST AMOUNTS

370. In the Discussion Paper the Commission seeks submissions on whether or not to make a fixed principles provision that states that in the next regulatory period, no adjustments will be made to compensate the Access Provider for, or recoup from the access provider, any differences between actual and forecast operating and capital expenditures in the previous regulatory period.[230] The Commission considers that such a provision would implement the efficiency benefit sharing scheme proposed in sections 6.2.5 and 7.3.4 of the Discussion Paper.[231]

371. Telstra submits that there should be a fixed principles provision which provides that no relevant adjustments will be made where outturn amounts are different to forecast amounts which have been accepted by the Commission for a relevant regulatory period. This is for two primary reasons. The first is to provide the Access Provider with an incentive to outperform the prudent and efficient benchmark expenditure levels accepted by the Commission prior to a regulatory period commencing. The second is regulatory certainty – the Access Provider and Access Seekers know upfront, at the commencement of a regulatory period, the operating and capital expenditure amounts that will form part of the annual revenue

[228] Clauses 6.5.6 and 6.5.7 of Chapter 6 (distribution) and clauses 6A.6.6 and 6A.6.7 of Chapter 6A (transmission).

[229] National Electricity Law (Schedule to the *National Electricity (South Australia) Act 1996* (SA)), section 2D.

[230] Discussion Paper, p 256.

[231] Discussion Paper, p 256.

requirement, and that there will be no adjustments to these amounts over the relevant regulatory period, or at the end of that regulatory period. Any mechanism that would allow the Commission to make retrospective adjustments would only reduce certainty.

4.1.7. WACC COMPONENTS

372. In the Discussion Paper the Commission seeks submissions on what components of the WACC should form fixed principles provisions.

373. Telstra agrees with the Commission's fixed principle provision in clause 6.8, that a real vanilla WACC will be used in estimating prices.

374. Telstra considers that it would be beneficial from the perspective of regulatory certainty that the fixed principles provisions specify that the cost of equity will be estimated using the domestic CAPM. This is consistent with the Commission's proposal in the Discussion Paper that the cost of equity be measured using the domestic CAPM.[232]

375. Telstra also considers that it would be beneficial from the perspective of regulatory certainty to provide in the fixed principles provisions that the risk free rate will be determined on a moving average basis from the annualised yield on Commonwealth Government bonds with a maturity of 10 years using the indicative mid rates published by the Reserve Bank of Australia. Telstra proposes a fixed principle provision which would permit the Access Provider to propose an averaging period to the Commission which would either be agreed by the Commission (such agreement not to be unreasonably withheld) or, if the Commission did not agree, a period specified by the Commission and notified to the Access Provider within a reasonable time prior to the commencement of the averaging period.

376. Telstra's proposal with respect to the averaging period is drawn upon similar provisions in the National Electricity Rules.[233] Telstra's proposal is also consistent with the Commission's previous statements on the nomination of an averaging period by a service provider (in the context of electricity transmission network service providers (**TNSPs**), where the Commission has stated:

    (a) TNSPs should have a better understanding of their bond portfolio management strategies;

    (b) there is no basis to believe that a TNSP would be advantaged or disadvantaged by the length of the sampling period, so long as the TNSP can appropriately hedge over the sample period; and

    (c) the ability of TNSPs to game with the length of period used in calculating the moving average is minimal because a TNSP has to specify the averaging period at the time of submitting its application for a revenue reset and cannot change it afterwards;

    (d) the Commission considers that the period (between 5 to 40 days) used to calculate the moving average of the bond rate should be left to the discretion of the TNSP when making its application, however the TNSP will not be allowed to change the averaging period after the application is lodged.[234]

377. Including in light of the above comments of the Commission, Telstra submits that it is appropriate for there to be a fixed principles provision that provides for the Access Provider to propose an averaging period to the Commission for the Commission's agreement (such

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[232] Discussion Paper, p 256.

[233] Clause 6.5.2(c)(2) of Chapter 6 (distribution) and clause 6A.6.2(c)(2) of Chapter 6A (transmission).

[234] ACCC, *Statement of Principles for the Regulation of Electricity Transmission Revenues – Background Paper: Decision*, 8 December 2004, pp 97 – 98.

agreement not to be unreasonably withheld). To the extent the Commission does not agree with the averaging period proposed by the Access Provider, the Commission would then specify a period and notify that to the Access Provider within a reasonable time prior to the commencement of that period.

4.1.8. TAX ASSET BASE NOT TO BE SET EQUAL TO THE RAB

378. The proposed fixed principles provisions in the Discussion Paper provide that the initial opening tax asset base at 1 July 2009 is to be set equal to the initial opening RAB as at 1 July 2009.[235]

379. As noted earlier in this submission (section 2.2), Telstra's actual corporate income tax expenses are based on the tax value of assets. The tax value of Telstra's network assets included in the Commission's FLSM are on average [c-i-c commences] [c-i-c] [c-i-c ends] than the value of Telstra's network assets as reflected in the Commission's FLSM.

380. For the reasons set out earlier in this submission, Telstra does not consider it appropriate for the initial tax RAB at 1 July 2009 to be set equal to the initial opening RAB value. Telstra submits that the initial opening tax asset base as at 1 July 2009 should be set at [c-i-c commences] [c-i-c] [c-i-c ends].

381. Telstra otherwise agrees that it is appropriate from the perspective of regulatory certainty for the initial tax asset base to be specified as a fixed principles provision.

382. Telstra also agrees that it is appropriate for the fixed principles to provide that the tax rate used in determining tax liabilities in the BBM be set equal to the corporate tax rate as specified in subs 23(2) of the *Income Tax Rates Act* 1986 (Cth).

4.1.9. VALUE FOR GAMMA TO BE SET TO 0.25

383. Telstra considers that following from the recent determination of the Australian Competition Tribunal on the value for gamma to apply to three electricity distributors, that it would be appropriate to include in the fixed principles provisions that the value to be adopted for gamma is 0.25. This is discussed in section 2.1.3.

4.1.10. FORECASTS OF DEMAND

384. In the fixed principles provisions in the Discussion Paper, the Commission proposes that in forecasting demand the Commission will take into account any forecasts provided by the Access Provider and that in assessing these forecasts, the Commission will consider whether these forecasts:

    (a) are based on an appropriate forecasting methodology;

    (b) are based on reasonable assumptions about the key drivers of demand;

    (c) utilise the best available information, including historical data that can identify trends in demand; and

    (d) take account of current demand and economic conditions.

385. Telstra submits that the fixed principle provision proposed by the Commission in relation to demand is generally appropriate and should apply to the forecasting of demand in any regulatory period to which an access determination will apply.

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[235] Clause 6.9.

4.1.11. NO VARIATION OR SUBSTITUTION OF FORECAST AMOUNTS ONCE ACCEPTED BY THE COMMISSION

386. Telstra submits that it would be appropriate, from the perspective of regulatory certainty, for a fixed principle provision to be included which states that once the Commission has accepted a forecast amount for the purposes of making a FAD, those forecast amounts will not be varied or substituted for the period to which the forecast relates. Any mechanism that would allow the Commission to make retrospective adjustments would only reduce certainty.

4.1.12. METHOD FOR THE CALCULATION OF THE ANNUAL REVENUE REQUIREMENT TO BE STATED

387. Telstra submits that it would also be appropriate, from the perspective of regulatory certainty, for a fixed principle provision to be included which states what the annual revenue requirement for each regulatory year must include. Particularly in circumstances where the FLSM does not form part of the fixed principle provisions, it would be desirable to provide that the annual revenue requirement for each regulatory year must include:

    (a) an allowance for depreciation of the RAB, calculated on a straight line basis;

    (b) a return on the remaining value of the RAB, calculated by multiplying the opening value of the RAB for that regulatory year by the WACC;

    (c) forecast operating expenditure for that regulatory year; and

    (d) an allowance for tax liabilities.

388. Together with the other fixed principles provisions, including the initial RAB, the roll-forward of the RAB, the calculation of the WACC and the forecasting of capital and operating expenditure, the proposed fixed principles provision stating the inclusions in the calculation of the annual revenue requirement provides certainty as to how the relevant inputs are used to generate the revenue requirement.

4.1.13. ANNUAL REVENUE REQUIREMENT TO BE ALLOCATED BETWEEN FIXED LINE SERVICES AND COST ALLOCATION FACTORS TO ADD TO 100%

389. The Commission has proposed a fixed principles provision dealing with cost allocation factors. Telstra agrees that such a provision is appropriate.

390. Telstra submits that it would be appropriate for the fixed principles provision to also provide that the entire annual revenue requirement for each regulatory year must be allocated between the fixed line services and that the allocation factors must add to 100%. Such a provision will assist in ensuring that the legitimate business interests of the Access Provider are protected and that the direct costs of providing access to the fixed line services are taken into account.

4.1.14. PRICES TO BE SPECIFIED IN CURRENT (NOMINAL) DOLLARS

391. Telstra has reviewed section 4.3.3 of the Discussion Paper which relates to, amongst other things, the Commission's decision to adopt a real approach to estimating prices, as opposed to a nominal approach. The illustration of the calculation process in the FLSM in figure 4.2 highlights some of the complexities of undertaking real calculations in the FLSM.

392. Telstra considers that a fixed principle provision that explicitly provided that prices for the fixed line services are to be expressed in current (nominal) dollars would assist in providing regulatory certainty as to how the FLSM is to operate (particularly in circumstances where

the FLSM itself is not embedded as a fixed principle provision). Therefore, Telstra submits that the following fixed principle provision should be added:

> *Prices for the fixed line services must be expressed in nominal dollars of the regulatory year in which they are to take effect.*

4.1.15. TELSTRA PROPOSED FIXED PRINCIPLES PROVISIONS PROMOTE LEGISLATIVE CRITERIA

393. Telstra agrees with the Commission that fixed principles provisions may operate to promote regulatory certainty and provide greater price stability. Properly specified fixed principles provisions that provide regulatory certainty and pricing stability will also be consistent with the relevant legislative criteria in s 152BCA of the CCA, in particular the promotion of the LTIE and the interests of all persons who have rights to use the relevant declared services.

394. However, Telstra considers that a number of amendments are required to the proposed fixed principles provisions in the Discussion Paper in order to properly achieve this aim of regulatory certainty and greater price stability. Critical elements of the regulatory framework – including the roll-forward of the RAB between regulatory periods, details around the WACC, and the method of calculating the annual revenue requirement – need to be clarified and codified in fixed principles provisions to provide a greater degree of regulatory certainty and to reduce potential future areas of disputation around the application of the regime.

395. Telstra has started with the Commission's proposed fixed principles provisions and has made the minimum number of changes that it considers would be necessary for this aspect of the FADs to provide greater regulatory certainty and price stability. In so doing, Telstra considers that the proposed fixed principles provisions would operate in a manner to promote the LTIE, assist in protecting the legitimate business interests of the Access Provider as well as the interests of Access Seekers, and would help in ensuring that the Access Provider is afforded an opportunity to recover the direct costs of providing access to the fixed line services.

4.2. Prices to be exclusive of taxes

396. The service prices calculated in the FLSM and proposed in the Discussion Paper include an allowance for corporate income tax but do not necessarily include an allowance for other taxes and Government levies that may be payable by Telstra in the provision of its fixed line services. The clearest example of a tax charged by Telstra to Access Seekers that is not represented in the service prices is the GST. Telstra submits that the FADs should explicitly state that service prices are exclusive of taxes and levies where no allowance has been made for these in the prices set out in the schedules to the FADs, and should allow Telstra to recover the cost of these amounts from Access Seekers as an additional unit cost.

397. Some of these taxes are payable in certain jurisdictions and not others, meaning that recovery across all jurisdictions (for example as a component of operating expenditure) would be inappropriate. An example previously raised by Telstra, and specifically referred to by the Commission in the Discussion Paper, is the Utilities Tax payable in the Australian Capital Territory under the *Utilities (Network Facilities Tax) Act 2006* (ACT).[236] This tax is payable by the owner of any network facility located on land in the ACT and is determined by reference to the length of the facility. In the 2008/09 tax year (ie from 1 April 2008 to 31 March 2009), Telstra paid [c-i-c commences] [c-i-c] [c-i-c ends] in Utilities Tax in the ACT. This amount was calculated by multiplying the route length of Telstra's network facilities in the ACT and Jervis Bay, NSW by the rate of $697 per kilometre of route length.[237] Telstra

[236] Telstra, *Pricing Principles for Fixed Line Services: Response to the ACCC's Draft Report*, October 2010, p 146; Telstra, *Response to the ACCC's draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, October 2009 (confidential version), pp 111-118.

[237] Taxation Administration (Amounts payable - Utilities (Network Facilities Tax)) Determination 2008 (No 2), 13 August 2008

proceeded to recover an amount of $1.85(excluding GST) per eligible SIO from its wholesale customers in the 2009/10 financial year.

398. Further, in addition to taxes currently incurred in providing fixed line services, Telstra may be required to pay new taxes in the future, such as a carbon tax. To the extent that new taxes are levied in the future which are attributable to the supply of fixed line services and which have not been incorporated in the FLSM and therefore the prices for the declared fixed line services, Telstra should be entitled to recover the cost of these taxes through an additional charge to the prices specified in the FADs for the declared fixed line services. The simplest way to ensure such recovery would be for the FADs to express prices as being exclusive of applicable taxes and Government levies, except to the extent these taxes are otherwise explicitly accounted for, or represented in, the prices in the schedules to the FADs.

399. Telstra notes that the Commission has previously made provision for the recovery of such taxes in its arbitration of access disputes. For example in its final determination of the access dispute notified by Chime on 26 June 2008, the Commission explicitly excluded "any reasonable amount which Telstra may impose in order to recover tax paid by Telstra pursuant to the *Utilities (Network Facilities Tax) Act 2006* (ACT)".[238]

400. Other building block pricing frameworks also include mechanisms for the recovery of taxes and levies. For example, under the National Electricity Rules, taxes other than corporate income taxes may be recovered either as a component of operating expenditure (where foreseeable) or as a direct pass through.[239] As noted above, Telstra is not in a position to include all taxes and levies in its operating expenditure since it operates nationally but only pays certain taxes in particular jurisdictions (in contrast to state and territory-based energy network businesses). Accordingly, Telstra's national pricing determined by the Commission in the FADs should be expressed as exclusive of all taxes except to the extent they are otherwise explicitly accounted for, or represented in, the prices specified in the schedules to the FADs, effectively allowing for direct pass-through of these tax liabilities where they are incurred.

401. To this end, Telstra proposes that the following clause be included in the FADs in each of schedules 2, 3, 4, 5, 6 and 7:

> *Unless otherwise stated, these prices do not include any reasonable amount which the Access Provider may impose in order to recover any tax liability incurred in providing the service where that tax liability is not accounted for, or otherwise represented in, these prices. The Access Provider is entitled to charge a reasonable amount in addition to the prices in this schedule to recover any tax liability incurred in providing the service.*
>
> *In this clause: "tax" means: any tax, goods and services tax, levy, impost, deduction, charge, rate, rebate, duty, fee or withholding, which is levied or imposed by any government, government department, instrumentality, agency, statutory authority or other body in which a government has a controlling interest, including any amount which arises from a change to, or the introduction of, any law (whether the change or introduction is retrospective or not).*

4.3. There is no basis to introduce record keeping rules to obtain Telstra's forecasts

402. In relation to record keeping rules (**RKRs**), in the Discussion Paper, the Commission maintains its view that a formal RKR should be implemented to obtain Telstra's expenditure and demand forecasts for future regulatory periods. The Commission notes that:[240]

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[238] ACCC, *Access dispute between Chime Communications Pty Ltd (access seeker) and Telstra Corporation Limited (access provider) – Unconditioned Local Loop Service (ULLS): Final Determination under Section 152CP of the Trade Practices Act 1974*, 7 April 2010, Schedule 1, Clause 3.

[239] In Chapter 10 of the NER, a pass through event is defined to include a "tax change event", which may occur where there is a change, imposition or removal of any tax payable by the business, except for income tax, stamp duty or any penalty for late payment of taxes.

[240] Discussion Paper, p. 34.

The ACCC considers that setting out these requirements in the proposed BBM RKR will increase regulatory certainty by ensuring that Telstra is aware of its information obligations and has sufficient notice of when its forecasts will be required.

A formal RKR will provide transparency for all industry participants. The ACCC considers that transparency in implementing the BBM is crucial to ensuring all industry participants have a high degree of confidence in the ACCC's new pricing approach.

The ACCC will consult broadly on the proposed BBM RKR in due course after the FADs are issued for the fixed line services. The ACCC considers that conducting the consultation concurrently with the FAD inquiry would place too high a regulatory burden on industry participants. Also, changes may be made to the information required under the BBM RKR following the current FAD consultation period.

403. Telstra maintains its previous position that it does not consider the introduction of RKRs to be either necessary or appropriate to obtain Telstra's demand, operating expenditure and capital expenditure forecasts.

404. Telstra has had a productive working relationship with the Commission throughout this consultation process and has provided updated forecasts to the Commission on a voluntary basis on several occasions. Telstra is unaware of any deficiency in this process which would indicate a likely impediment to the future information collection by the Commission.

405. Further to this, Telstra considers that there is no basis for the Commission to claim that the introduction of an RKR would increase regulatory certainty or transparency. The Commission does not point to any evidence which demonstrates that an informal process does not achieve these two outcomes nor does the Commission point to any evidence to show that a formal RKR process would increase these two principles.

406. Instead, an RKR process would result in the disclosure of a significant proportion of Telstra's confidential information that is provided under the RAF RKR. Such disclosure would cause significant and ongoing commercial harm to Telstra by prejudicing its position in respect of competitors, suppliers, market analysts and investors. Indeed, Telstra notes that the sensitive nature of the RAF data has been previously acknowledged by the Commission and Access Seekers. Where RAF data has been disclosed to Access Seekers previously, it has been disclosed through a stringent confidentiality process.[241]

407. Despite Telstra's concerns about an RKR or formal mechanism related to Telstra's expenditure and demand forecasts, if the Commission presses ahead with an RKR, it must be targeted to the data that is required and go no further. It must also include appropriate, high levels of protection around Telstra's confidential information.

[241] Telstra refers the Commission to its confidential letter of 31 January 2011 where it sets out in detail its concerns in relation to the introduction of the written direction pursuant to section 151BUC of the *Competition and Consumer Act 2010* (Cth) requiring Telstra to publicly release copies of certain periodic regulatory financial reports provided to the Commission under the RAF RKR.

5. CONCLUSION

408. In responding to the Part A and Part E of the Discussion Paper and draft FADs Telstra has identified, and addressed in this submission, four main areas requiring review:

- The setting of the initial RAB, without proper regard to the value of Telstra's investment in its fixed line network.
- Other costs which are not properly reflected in the Commission's cost model.
- Total costs which are not properly converted into prices.
- The failure of the proposed regulatory instruments to provide certainty and require amendment.

409. Notwithstanding that Telstra has fundamental concerns about certain aspects of the Discussion Paper's approach, these concerns are not new: the issues they address have been well covered in past submissions, with supporting evidence, and flagged in discussions with the Commission since the Discussion Paper was issued.

410. Notwithstanding the weight of material provided by Telstra in the past, it is evident that the Discussion Paper does not adequately deal with these issues.

411. Telstra welcomes the opportunity in responding to the Discussion Paper with this submission, to make clear where its concerns arise and to set out how they can be addressed in a practical and pragmatic manner, consistent with a proper weighing and consideration of the relevant legislative criteria. For its part, Telstra seeks early resolution of outstanding issues, and is looking forward to a timely resolution of the FADs, in order to provide regulatory certainty that is fundamental to the industry's future.

412. At the most fundamental level, Telstra is concerned that the introduction of a building block methodology in relation to the TSLRIC+ and RMRC frameworks, which have applied since the publication of the Commission's 1997 Access Pricing Principles, ought not to have been an opportunity to fundamentally revalue Telstra's investments in its fixed line network and to implement a new model that does not allow it to recover the appropriately allocated anticipated futures costs of providing fixed line services.

413. However, that has been the result. The approach in the Discussion Paper: substantially reduces the value of Telstra's investment; results in the value of that investment and future capital and operating expenditure being unable to be recovered by reason of the allocation of unit costs on the basis of fictional levels of SIOs and OTA minutes; does not provide Telstra an appropriate risk adjusted rate of return on its investments; mandates nationally averaged OTA prices in such a way so that Telstra will not be able to recover its costs; and establishes an ongoing regulatory framework that will not provide regulatory certainty and predictability.

414. In important respects, identified in this submission, the reasoning in the Discussion Paper lacks fundamental evidential support for key assumptions and lacks inherent rationality. The Commission has adopted a regulatory approach manifestly at odds with regulatory precedent, including its own, and regulatory best practice, including as reflected in the expert opinions of leading international regulatory economists.

415. The result is draft FADs that are manifestly unreasonable. They cannot be rationally supported by reference to a weighted and meaningful consideration of important legislative criteria, including most relevantly:

    (a) The LTIE consideration of the impact on the incentives for investment in infrastructure; and

    (b) Telstra's legitimate business interests in: recovering through prices for declared services the value of its past investments and future investments; recovering its capital and operating costs of providing fixed line services over its network; and not being subject to arbitrary regulatory decisions.

416. The Commission has acknowledged the risk to investment incentives (a fundamental statutory criterion) of regulatory opportunism. It is critical, that in transitioning from one regulatory methodology (TSLRIC+ and RMRC) to another (building blocks) that it do so in a way that provides principled consistency and predictability, so as to avoid manifesting regulatory opportunism that would give rise to this risk.

417. In bringing this process to an end, Telstra submits that the Commission must give full and proper consideration to the material that Telstra has submitted and to identified relevant matters it has set out. Having regard to that material, in Telstra's submission, the appropriate way forward for the Commission is clear, the Commission should now:

    (a) Adopt a valuation for Telstra's fixed line assets that is consistent with previous valuations, so as to avoid unnecessary and potentially harmful devaluation;

    (b) Correct the other errors in the FLSM identified in this submission, including those in relation to cost allocation and calculation of prices;

    (c) Adopt prices based on the appropriate valuation and corrected FLSM which provide for regulatory certainty and price stability and a smooth transition into the next regulatory chapter, including de-averaged PSTN OTA prices and WLR prices averaged across all line, not just WLR lines; and

    (d) Adopt the fixed principles set out in Schedule A.8 and clarify that prices are to be exclusive of taxes, and forbear from introducing a record-keeping rule regarding Telstra's expenditure and demand forecasts.

418. As Telstra has demonstrated in this and its previous submissions it is possible to achieve regulatory certainty and price stability through a reasonable valuation that is consistent with previous Commission decisions and a properly constructed FLSM. For the reasons set out in this submission, Telstra submits that the Commission has not properly taken into account the legislative criteria which necessarily require that the FADs would allow Telstra to be able to recover the value of its investments and other costs, among other considerations. Given this, the Commission's approach reflected in the Discussion Paper and the FADs cannot be sustained and must be amended.

419. Finally, should the Commission seek to make other adjustments to the FLSM that have not been discussed in detail, Telstra requests the opportunity to comment on those changes prior to the Commission making FADs. Telstra will provide comments on these adjustments expeditiously so as not to hinder the Commission's timeframes.

SCHEDULES

SCHEDULE NUMBER	TITLE
A.1	**David Sappington, *The ACCC's New Approach to Setting Access Prices*, 2 June 2011**
A.2	**Critique of CEG's asset valuation**
A.3	**Historical background [confidential in part]**
A.4	**Technical analysis of inflation effects**
A.5	**KPMG, *Calculation of revenue impact from changing demand volumes*, May 2011 [confidential]**
A.6	**Confidential schedule containing Telstra's confidential information in Part A [confidential]**
A.7	**PSTN OTA explanation of calculations** **PSTN OTA calculations [confidential]**
A.8	**Suggested drafting for fixed principles**
A.9	**Analysis of materiality of the Commission's errors [confidential]**
A.10	**Revised schedule 9 to Telstra's response to the Commission's request for further information dated 19 November 2010 [confidential]**