



# **Submission on the ACCC's Final Access Determinations for Fixed Line Services**

**A REPORT PREPARED FOR THE COMPETITIVE CARRIERS'  
COALITION**

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## Executive Summary

Frontier Economics (Frontier) has been engaged by the Competitive Carriers' Coalition to analyse and comment on the ACCC's discussion paper released in support of its proposed final access determinations (FADs) for the declared fixed line telecommunications services.

### ***One step forward; two steps back***

The ACCC's discussion paper is the latest in a series of reports and papers that are changing the mechanics of access pricing for fixed line services. Central to this change is the movement away from revaluing the asset base used to provide these services each regulatory period, and instead moving toward using a building-block model (BBM) that "locks in" a regulatory asset base (RAB).

Frontier has made a number of submissions to the ACCC on this issue. We welcome many of the changes proposed by the ACCC during this process, and the opportunity this represents to reduce industry disputes in the future.

While we support the broad thrust of the ACCC's move towards a BBM and 'locking in' a RAB, we nonetheless believe there are many issues of detail in the way the ACCC has sought to implement its new pricing methodology which threaten to undermine much of the progress made over the last 18 months or so.

### ***The focus on price stability puts the cart before the horse***

Of greatest concern is the apparent priority placed on maintaining "price stability" for the ULLS. Rather than develop a BBM methodology and build-up a cost estimate using appropriate data, the ACCC has instead set out to maintain the current price of the ULLS and reverse engineer a value for the RAB that would be consistent with this price. The fallacy of this approach is that existing prices were estimated partly using a forward-looking optimised replacement cost (ORC) pricing methodology – the so-called "forward-looking TSLRIC pricing methodology". By reverse engineering a RAB from existing prices based on the previous methodology, the ACCC is effectively "locking-in" for many years to come the very costing methodology it was seeking to abandon. This is totally at odds with the purpose of the recent changes to the ACCC's pricing methodology, which had been aimed at moving away from setting prices based on a forward-looking costing methodology.

More broadly, it is greatly concerning that the ACCC would seek to estimate cost from its existing prices. The approach applied in the ACCC's FAD resembles that of a "goal-seeking" exercise, where the price to be set is determined in advance, and the regulator then works backwards to figure out supporting reasons for this price. Rather than estimate cost appropriately and then set a price based on this (as the ACCC and other best practice regulators have consistently

sought to do in the past), the ACCC appears now to start with a final price in mind and backwardly induct a methodology to support this conclusion. We do not believe this type of approach is well principled, nor do we believe it is likely to meet the section 152BCA legislative criteria, and in particular the long-term interests of end-users (LTIE). In particular, our report finds that the approach:

- leads to a higher RAB value that offers no material benefits in terms of competition or efficiency, and means that access seekers will pay twice for investments only made once.
- it places the highest weight on price stability, which (at least to our knowledge) has never before been considered a relevant factor under the section 152BCA criteria to which the ACCC is required to have regard.<sup>1</sup>

We also believe it is unnecessary for the ACCC to set the initial RAB in this way given the availability of historic cost information.

### ***Specific points of concern***

In addition to our general concerns about the reverse engineering of the initial RAB, we are also concerned about a number of specific aspects of the way prices in the FADs have been estimated. In particular, our submission finds that:

- In order to maintain current ULLS prices, the ACCC has artificially “pumped up” the value of the RAB by \$1.44 billion. This has been achieved by simply increasing the total amount of costs allocated to the ‘ducts and pipes’ asset class by this entire amount. We believe there is no basis either in economics or the legislative criteria for this random allocation of value. That the ACCC does so serves to reinforce the perception that its sole intention here is to preserve the ULLS price at existing levels regardless of the information it has before it.
- The ACCC’s treatment of land in the RAB roll forward is incorrect and should be adjusted to ensure that the expected net present value of Telstra’s expenditures is equal to zero: the basic BBM condition.
- The ACCC’s proposal to lock in a 5-year regulatory period in the present circumstances is particularly concerning. This is because of:
  - the lack of detailed information released on critical forecasts upon which prices in the FAD are based, including explanations and justifications for

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<sup>1</sup> While the criteria set out in section 152BCA(1) have only recently been inserted into the Competition and Consumer Act (Act), they essentially replicate the reasonableness criteria that have been used by the ACCC and the Australian Competition Tribunal to assess and set telecommunications access prices under section 152AH(1) of the Act.



the forecasts adopted, and breakdowns of the cost categories and cost drivers for these costs

- the significant revisions to these forecasts since September 2010, including a [c-i-c] million increase in indirect operating expenditure and a [c-i-c] million increase in indirect capital expenditure (which was not even included in the September 2010 forecasts)
- continuing concerns about the indexing methodology employed by the ACCC in calculating its direct operating expenditure forecasts, potentially adding \$90 million to annual operating expenditure
- uncertainty about how the ACCC has assessed the mark-up proposed for indirect operating expenditure. Further, we believe there is no clear basis for choosing more than a 60% mark-up over direct operating costs
- uncertainty about the circumstances under which the ACCC will re-open consideration of prices set under the FAD
- concerns that the incentive mechanisms implied by the pricing methodology are too high-powered

In short, there is considerable uncertainty about future forecasts of key variables due to the current telecommunications policy environment and the commencement of this new pricing regime. Further, the ACCC appears in places to have “blind faith” in material provided by Telstra. In these circumstances, there is significant risk that the prevailing uncertainty around variables could result in large gaps between prices and actual costs – thereby leading to substantial unanticipated revenue gains or losses for Telstra.

- The regulatory period for the initial FAD should be no longer than 3 years – which would coincide with the end of the fixed line declarations. This could be introduced in conjunction with fixed principles, which would substantially mitigate any pricing uncertainty for access seekers and Telstra.
- The ACCC’s proposal to average PSTN OTA charges would not be in the LTIE or otherwise consistent with the criteria under Section 152BCA. In particular, and consistent with previous findings of the ACCC and the Australian Competition Tribunal in relation to pricing of fixed-line telecommunications services, geographically averaged charges are not likely to promote competition or encourage the economically efficient use of or investment in telecommunications infrastructure.
- The ACCC’s claim that access seekers could negotiate geographically de-averaged arrangements with Telstra is incongruous and inconsistent with the history of access negotiations in Australia over the past 14 years.

Finally, our report also comments on a range of other price setting issues in the draft FAD, including data traffic forecasts and related cost allocations, price smoothing, and the treatment of the LSS.

# 1 Introduction

The Competitive Carriers' Coalition has asked Frontier Economics (Frontier)<sup>2</sup> to analyse and comment on the ACCC's discussion paper released in support of its proposed final access determinations (FADs) for the declared fixed line services.

## 1.1 The ACCC's discussion paper and finalising the FADs

The ACCC's discussion paper is the latest in a series of reports and papers that are changing the mechanics of access pricing for fixed line services. Frontier has made a number of submissions to the ACCC about this change, and, in many cases, we welcome the change and the opportunity it represents to reduce industry disputes.

In Part A of its discussion paper, the ACCC addresses a number of issues that are pertinent to the development of prices for the declared fixed line access services. In particular, the paper sets out how the ACCC proposes to implement a building block model (BBM) for Telstra's fixed line network.

While we support the ACCC's move towards a BBM and 'locking in' a regulatory asset base (RAB), there are many issues of detail which the ACCC needs to get right to ensure that its FADs meet the section 152BCA legislative criteria, and in particular, are in the long-term interests of end-users (LTIE).

In many areas, the discussion paper represents a substantial improvement on the Draft Report on Access Pricing Principles in September 2010 – a process since superseded. However, we note with some concern that the ACCC has reached a view that 'many of the pricing issues are substantially resolved' and that it will move straight to publishing a final set of FADs.<sup>3</sup>

Our opinion is that the ACCC should not rush into a final decision on the FAD. A change in access pricing methodology is a major undertaking, particularly as we now seek to rely on new sources of data which are essentially untested and therefore require careful scrutiny (more so than might be required, say, at regular regulatory resets).

As it currently stands, an FAD will lock in 5 years of prices that may very well be misaligned with the costs of supplying the services over this period. The ACCC

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<sup>2</sup> The project team from Frontier was Warwick Davis, Stephen Farago and Richard York.

<sup>3</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services*, Discussion paper, April 2011, p. 2.

needs to consider carefully whether the benefits of making a quick decision outweigh the potential costs, including the potential costs of having to re-open a price control that diverges sharply from reality.

## 1.2 Structure of this report

In this report, we have broadly followed the ACCC's order of issues set out in the Discussion paper. We have organised our analysis as follows:

- the approach to the setting of the opening RAB (Section 2)
- the rolling forward of the RAB (Section 3)
- the five year period of the FAD, including comments on the operating and capital expenditure forecasts (Section 4)
- the approach to geographic averaging of certain charges (Section 5)
- cost allocations and other pricing issues (Section 6).



## 2 The opening RAB value is inflated

The ACCC proposes to change its approach to setting the opening RAB from that set out in the September 2010 draft report (which Frontier supported). It now chooses a value in between the lower and upper bands represented by depreciated historic value (DAC), and depreciated optimised replacement cost (DORC). This value is chosen by a method which the ACCC describes as follows (p. 47):

...the ACCC has decided to maintain the \$16 ULLS price in Band 2 included in the IADs. In addition, for the reasons set out in chapter 11, the ACCC decided that a single ULLS price of \$16 should apply in Bands 1 to 3.

To determine a RAB value consistent with an averaged ULLS Band 1 to 3 price of \$16, the ACCC calculated the net present value of the cash flows expected from the ULLS Band 1 to 3 price and the prices for the other fixed line services estimated by the FLSM as being consistent with the \$16 ULLS Band 1 to 3 price. The relativities between these prices and the ULLS Band 1 to 3 price are determined within the FLSM based on the relative costs of providing those services (see chapters 10 and 11).

The net present value calculation implies an initial opening RAB value of \$17.75 billion as at July 2009, when the increment above the RAB estimate of \$16.31 billion (based on a DAC value with indexed land asset values) is allocated to the 'ducts and pipes' asset class.

The ACCC's reasoning for the net present value (NPV) approach is that (p. 47):

In making this adjustment, the ACCC was guided by the principle that pricing stability is desirable to the extent that it supports past investments and promotes industry confidence in making future investment decisions....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.

The ACCC later suggests that 'pricing stability' is in the legitimate business interests of the access provider (p. 183.)

While we accept that the NPV approach is a valid methodological approach in certain circumstances, we do not accept that its use here would promote the LTIE or be in the legitimate business interests of access seekers or Telstra. The ACCC's NPV approach:

- is unnecessary, given the availability of historic cost information
- locks in prices set by previous TSLRIC models, and is implicitly based on an ORC/DORC valuation
- offers no material benefits in terms of competition or efficiency, and means that access seekers will pay twice for investments only made once.

## 2.1 The NPV approach does not best meet key legislative criteria

The ACCC's rationale for the NPV approach, outlined above, is that maintaining current prices best meets the legislative criteria of encouraging efficient investment (under the LTIE criterion) and protecting Telstra's legitimate business interests.<sup>4</sup>

Our view is the NPV approach for setting the opening RAB does not best promote these legislative criteria, or the other 152BCA criteria. In a previous submission to the ACCC, we analysed the suitability of an NPV approach for asset valuation (before the specifics of the ACCC's new approach were known). We commented that:

This could well mean that the chosen set of prices is arbitrary (not related to efficiency or competition criteria) and non-transparent.

Moreover, if the existing (or future) regulated prices for the service are used to derive the RAB as suggested by the ACCC, this will in essence retrieve the

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<sup>4</sup> The full criteria that the ACCC must take into account under Section 152BCA are as follows:

- (1) The Commission must take the following matters into account in making an access determination:
  - (a) whether the determination will promote the long-term interests of end-users of carriage services or of services supplied by means of carriage services;
  - (b) the legitimate business interests of a carrier or carriage service provider who supplies, or is capable of supplying, the declared service, and the carrier's or provider's investment in facilities used to supply the declared service;
  - (c) the interests of all persons who have rights to use the declared service;
  - (d) the direct costs of providing access to the declared service;
  - (e) the value to a person of extensions, or enhancement of capability, whose cost is borne by someone else;
  - (f) the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility;
  - (g) the economically efficient operation of a carriage service, a telecommunications network or a facility.
- (2) If a carrier or carriage service provider who supplies, or is capable of supplying, the declared service supplies one or more other eligible services, then, in making an access determination that is applicable to the carrier or provider, as the case may be, the Commission may take into account:
  - (a) the characteristics of those other eligible services; and
  - (b) the costs associated with those other eligible services; and
  - (c) the revenues associated with those other eligible services; and
  - (d) the demand for those other eligible services.
- (3) The Commission may take into account any other matters that it thinks are relevant.

asset value upon which those prices have been set i.e. a TSLRIC-based ORC valuation using the ACCC's indicative prices. In this sense, it would make more sense to simply use the TSLRIC opening asset value and lock this in. Of course, if prices captured in the RAB calculation also cover non-regulated services, then one imagines that the RAB valuation may also capture a degree of monopoly profit.

This approach therefore probably makes more sense in a situation where prices have been heavily influenced by non-economic considerations (e.g. kept low for social policy reasons), and, in the absence of accurate historical cost information, the regulator wishes to establish an initial RAB. This is not the situation for fixed network access services.<sup>5</sup>

These points remain valid. While the \$16 ULLS price is arguably not arbitrary, it does result from a prior TSLRIC valuation (as is clear from the ACCC's 2009 release on indicative prices):

A TSLRIC pricing methodology has been maintained for the ULLS since the first pricing principles for the service were released in March 2002. In June 2008, the ACCC released indicative prices for the ULLS for the period 2005-06 until 31 July 2009 as set out below [including a \$16 prices for band 2 ULLS]. At the same time, the ACCC determined that indicative prices based on TSLRIC+ pricing principles should be estimated using the PIE II network cost model until such time as the ACCC had developed its own fixed network cost model.<sup>6</sup>

Therefore, although the ACCC claims that the more substantial limitations associated with obtaining a DORC value has ruled it out as a starting point, the ACCC has essentially used an ORC / DORC value (based on the PIE II valuation) to derive its RAB as it is in essence based on the determination of the \$16 ULLS price using this methodology. It is difficult to square this with the ACCC's previously-expressed views that:

...a DORC valuation would be a complex, subjective exercise that is less transparent and verifiable than using actual costs under a DAC approach.<sup>7</sup>

The ACCC considers that a cost based approach that uses actual, objectively verifiable costs is more transparent and objective than a revenue based approach.<sup>8</sup>

Equally, we do not consider that the resulting NPV method is demonstrably better at promoting legitimate business interests or the efficient investment component of the LTIE than the corrected DAC values. The ACCC's argument is that price stability promotes the interests of the access provider and supports

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<sup>5</sup> Frontier Economics, *Setting the Regulatory Asset Base for the Fixed Network*, November 2009, p. 14-15.

<sup>6</sup> ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, August 2009

<sup>7</sup> Discussion paper, p. 53.

<sup>8</sup> September 2010 Draft report, p. 25.

past investments. This interpretation is novel and is not consistent with prior Australian Competition Tribunal findings as to the meaning of 'legitimate business interests', which clearly focuses on recovery of costs, e.g. in *Re Telstra Corporation Limited*.<sup>9</sup>

[89] ...We turn to the next statutory matter in s 152AH(1)(b) and have regard to the legitimate business interests of Telstra and Telstra's investment in facilities used to supply the LSS. Those legitimate business interests require that Telstra be allowed to recover its costs of supplying the LSS and achieve a normal return on its invested capital. The expression "legitimate business interests" is a general expression and is somewhat open-textured....When looked at through the prism of a charge term and condition of access and its relationship to a carrier's cost structure, it is a reference to the interest of a carrier in recovering the costs of its infrastructure and its operating costs and obtaining a normal return on its capital.

Put simply, if existing prices enable a firm to more than recover its efficiently incurred costs, price stability will simply entrench above-cost pricing into the future. In turn, this will enable the access provider to earn returns greater than those necessary to meet its legitimate business interests. It is therefore illogical to suggest that price stability of itself is in the legitimate business interests of an access provider – if this were the case a regulator would never change access prices at all, and Telstra should have been left to set the same prices for its services that it was setting at the start of the regulatory regime.

In defending its choice of the NPV method, the ACCC also appears to apply no weight to promoting the efficient *use* of the infrastructure by which the declared fixed services are supplied (see 16.1.1). Efficiency in the use of the fixed network will be best promoted by ensuring that the supply of services is encouraged wherever prices cover the marginal opportunity costs of network use. This favours setting the lowest possible asset value consistent with encouraging future investment in the network. As argued by King:

if the Commission wishes to maximise the economic benefits from access then it will want access prices to be as low as possible, subject to the relevant assets remaining in use...a higher asset value will result in higher access prices and will tend to reduce the economic benefits that can be achieved from the relevant final markets.<sup>10</sup>

As we now argue, the NPV approach is inferior to the DAC approach in this and in other respects.

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<sup>9</sup> ACompT 4 (2 June 2006)

<sup>10</sup> S. King, *Asset valuation and access*, ANU Centre for Economic Research: Discussion paper No. 365, April 1997, p. 14



## 2.2 DAC better meets the key legislative criteria

### 2.2.1 Criticisms of DAC are unfounded

The ACCC's primary reason for rejecting the use of DAC is that there are shortcomings in the available historic cost records contained in the RAF; particularly the possibility of incomplete asset records. However, the ACCC provides little indication of the materiality of this problem. Indeed, through the current process it appears to have made some important corrections to the RAF based on examination of material in Telstra's asset registers.

We are also unconvinced that the RAF has 'missing assets' or in some way understates the 'true value' of the CAN and core networks, for three reasons:

- The ACCC and Telstra have not produced any evidence that this is the case. The evidence presented on p. 58 is that assets are 'missing' because they have been fully depreciated (i.e. their value has already been fully recovered) rather than incorrectly recorded and understated.
- As we note further below, there is no basis for increasing the valuation of these assets unless there is some risk that they will be removed from the asset base if a value no less than scrap value is attributed to them.
- Thirdly, it is also arguable that these values may be more than offset by the fact that the ACCC makes no adjustments to the RAB to reflect asset redundancy or imprudency.

### 2.2.2 Analysis of past cost recovery supports the use of DAC

In section 5.5 of its discussion paper, the ACCC finds that the available evidence suggests that Telstra is unlikely to have under-recovered depreciation on its network assets under the previous TSLRIC approach. The ACCC compares returns from TSLRIC and straight-line depreciation directly.

We accept that considerations over past compensation are difficult. However, we believe it would be incongruous to consider only historic wholesale returns from the CAN and core networks. Telstra's returns on its CAN and core networks would have included significant returns from retail services. The ACCC's data suggests that in 2009-10, Telstra still supplied 78% of all end-users with fixed voice services over the CAN, and that this was a reduction on 2008-09, where Telstra possessed 80% of this market.<sup>11</sup> In fact, a reasonable proportion of Telstra's investments in the fixed network would have been made when it had 100% share of retail revenues (i.e. there are many assets in the CAN and CORE

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<sup>11</sup> Discussion paper, p. 230.

that have lives greater than 20 years, and were therefore invested in prior to when competition was first introduced).<sup>12</sup>

In our previous submissions on this issue, we have argued that Telstra's evidence supplied to the ACCC suggests that its returns have been high enough across retail and wholesale services to recover straight line depreciation of its assets. Its nominal returns, which are arguably more relevant and comparable with the RAF data because these use historic and unindexed data, indicate that, in fact, Telstra has been able to recover more than straight-line depreciation.

This result, which applies to the past couple of years, also seems consistent with the ACCC's earlier conclusions on returns on historic costs. In 2003, the ACCC found that:

Apparent rates of return from the PSTN are well in excess of Telstra's weighted average cost of capital.<sup>13</sup>

The profitability study revealed that over the last four years, on average, Telstra realised an economic profit, as a percentage mark-up on costs, of over [c-i-c]. This indicates that Telstra is more than just able to fully recover any AD [access deficit].<sup>14</sup>

These rates of return were calculated after (straight line) depreciation had been deducted from profits.

It is therefore puzzling that, despite its own finding and despite this other evidence, the ACCC has changed its asset valuation approach. The change in approach also seems at odds with the ACCC's earlier statement that an important objective of a BBM approach is to allow the access provider to recover its previous costs of investing in sunk infrastructure, and that the Tribunal had supported this approach as being in the access provider's legitimate commercial interest.<sup>15</sup> It is also at odds with the ACCC's assessment at 16.1.2 of Telstra's legitimate business interests:

The initial RAB value places a value on the network assets used by the access provider in providing the declared fixed line services. The ACCC considers that

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<sup>12</sup> While retail services have been subject to broad-based retail price controls, the 'X' values set for these have never taken into account the fundamental differences between prices and costs for services. Prior to 2005, an approach based on estimating total factor productivity (TFP) *changes* was used, and since 2005, the caps have been set well in excess of estimated TFP gains. See ACCC, *Review of Telstra's price control arrangements - an ACCC report*, March 2010, p. 30.

<sup>13</sup> ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*; October 2003, p. 45. See also the ACCC's study in 2001 which found that Telstra's EBIT return was well above its cost of capital for the years 1998-2001.

<sup>14</sup> *ibid.* p. 49.

<sup>15</sup> Discussion paper, p. 56.

a cost-based valuation approach will best promote the legitimate business interests of the access providers.<sup>16</sup>

While we agree with this opinion, it is not what the ACCC has actually done to derive the initial RAB value and service prices.

## 2.3 Allocating the ‘excess value’ to ducts and pipes is not warranted

### 2.3.1 No economics to support the allocation

The ACCC allocates the excess value from its NPV calculation (over and above the corrected DAC valuation) solely to ducts and pipes. This has the effect of increasing the prices of ULLS and WLR services, which are the primary services that are delivered using these assets.

The ACCC’s rationale for this allocation is that it:

took the view that the economic value of these assets is likely to be substantially higher than their depreciated historic values...since these assets are long-lived, they are more susceptible to the limitations of past accounting practices than other network assets...ducts and pipes are likely to be of continuing economic value for a fibre based network.

This explanation is not convincing. It is not clear what the ACCC means by ‘economic value’ in this context, as there is no relevant ‘economic value’ for sunk costs above their scrap value (opportunity cost). Scrap values provide the optimal valuation method for sunk assets if we are not concerned about future investment decisions. The only reason for ascribing a value to assets above their scrap value is to preserve investment incentives – by ensuring that the regulated firm can earn an economic return on its investments. There is no argument to suggest that these duct and pipe assets have any higher ‘economic value’ than any other asset.<sup>17</sup>

The other argument raised by the ACCC is that the accounting information on these assets is not accurate. However, we cannot see why the ACCC seeks to use this as a reason to attribute more value to ducts and pipes. Presumably, the main reason why assets that are still in use ‘drop off’ the asset register is that they have been fully depreciated and paid for by customers. To now ascribe a value to these assets because they are still being used just forces end users to pay more than once for these assets.

<sup>16</sup> Discussion paper, p. 180. Note this is inconsistent with later statements on p. 183.

<sup>17</sup> See e.g. the discussion in S. King, *Asset valuation and access*, ANU Centre for Economic Research: Discussion paper No. 365, April 1997, p. 14

If the ACCC is genuinely concerned about Telstra taking assets out of service because the value ascribed to these in the RAB is below their scrap value, then it should ensure that assets are valued at no less than their scrap value. Of course, if that was the ACCC's concern, it would be very unlikely to support an increase in the value of ducts and pipes. The duct and pipe assets are probably the most sunk of all of Telstra's assets (i.e. these assets have little value outside of their current use), and the scrap values are likely to be close to zero. Ascribing a higher value to these assets would achieve little other than to discourage efficient use of the assets, because this would result in prices that are further above the marginal opportunity cost of using the asset.

### 2.3.2 The Telstra – NBN Co deal?

A final issue to raise here is that it is not clear that the ACCC has taken sufficient account of how any prospective deal with NBN Co might alter the value ascribed to the duct and pipe network. We understand that it is quite plausible (although uncertain) that there will be a period where the ducts and pipes will be used by both the copper and fibre networks.<sup>18</sup> That is, there will not be a simultaneous cutover of services. This raises the question of how costs should be allocated between access seekers and NBN Co, as allowing Telstra to simply keep any revenues it is able to extract for renting ducts and pipes to NBN Co will provide for over-recovery. As we later suggest, the uncertainty that exists here is a good reason to avoid locking in prices for a long period.

### 2.3.3 Summary

In summary, we do not think the ACCC has good reasons for using a RAB higher than (corrected) DAC. But even if it did, it is far from clear that it makes economic sense to allocate this excess value solely to the ducts and pipes asset class.

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<sup>18</sup> Discussion paper, p. 112.

### 3 The ACCC should count land revaluations as income

The ACCC does not propose to treat land the same way that it treats other assets within the RAB. Rather, it proposes to allow re-valuations of land assets. That is, these values are not ‘locked in’.

The reason that the ACCC gives for this treatment is:

The ACCC is of the view that the value of land assets should be indexed to reflect the appreciation of land values over time.

In 6.1.1, the ACCC’s describes its proposal to roll-forward the RAB each year as follows:

$$RAB_{t+1} = RAB_t + capex_t - depreciation_t - asset\ disposals_t$$

However, from the FLSM, we can see that this equation is not actually what the ACCC is doing. Rather, the ACCC implicitly adds an additional term: “+ *Revaluations*”.<sup>19</sup> The significance of this is that it reveals that the ACCC is effectively re-adopting an approach it has already rejected. Further, because it provides for revaluations and *these revaluations are not counted as income*, they provide Telstra with a ‘free lunch’.

To explain, a cornerstone of any building block approach should be that it provides for investments to meet the condition of “expected NPV=0”. The ACCC agreed with this approach in its December 2009 discussion paper: “In both scenarios, however, the NPV of earnings is equal to the NPV of the access provider’s total investments.”<sup>20</sup>

To preserve that expected equality, it is well known that any revaluations that are included in the asset roll-forward must be accounted for as income. See e.g. Johnstone:

Any asset revaluation agreed to by the regulator amounts to an NPV windfall to asset owners equal to the amount of the (upward) revaluation. To prevent this “free lunch” the regulator must either prohibit asset revaluations or treat them explicitly as income in the tariff equation, thus reducing tariffs (cash flow) in the period of the revaluation by the amount of that revaluation.<sup>21</sup>

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<sup>19</sup> This may be seen at Row 321 of the “RAB Roll Forward” sheet of the FLSM.

<sup>20</sup> ACCC, *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services Discussion Paper*, December 2009

<sup>21</sup> D. Johnstone, “Replacement cost asset valuation and regulation of energy infrastructure tariffs”, *Abacus*, Vol. 39, No. 1, pp. 1-41, 2003.

Treating these gains in valuation as income is consistent with normal competitive markets in which returns are provided by both income and capital growth (i.e. capital gains). Capital gains themselves reflect an expectation of higher cash flows in the future, either through expected cash flows from revenue generated by employing assets to supply services, and/or through the sale of those assets.

Although we are not certain what the ACCC's rationale for this treatment of land is, it may be that the ACCC has misunderstood why it is legitimate to increase the value of land in the RAB. Land may legitimately be treated differently from other assets, because land is not sunk and has a realisable value<sup>22</sup> that is likely to be substantial. If land is attributed a value in the RAB that is below its realisable value, it may give Telstra an incentive to inefficiently dispose of land. For other assets, there are not likely to be any material incentive effects, regardless of what value is attached to these assets (i.e. because they are sunk and have little value in an alternative use).

If the ACCC wishes to increase the real value of land to avoid potential incentive problems, then it is quite legitimate to revalue these assets (or to allow for the expected revaluation of these assets). However, any such revaluations should be accounted for as income to ensure that only normal returns are made overall (meeting the expected NPV=0 condition). That is, the revenue requirement should equal:

$$RR_t = RAB_t \times wacc + opex_t + depreciation_t + tax allowance_t - revaluations_t$$

That this does not occur is obvious from the cash flow analysis in the FLSM, which indicates that the expected return to equity is above the cost of equity due to the land appreciation. Removing the revaluations from the revenue requirement corrects this and the ACCC should do this in the FSLM. Our calculation indicates that doing this will reduce the revenue requirement by \$18.8 million over the 5 years. In Box 1 below, we provide some illustrative detail about the nature and extent of the over-recovery.

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<sup>22</sup> Equivalent to the concept of scrap value for other type of assets..

**Box 1: Land revaluation example**

[c-i-c]

*Source: Frontier*

As the ACCC rolls forward the 2009-10 valuation to the 2011-12 financial year, it includes two years of land revaluations. The starting RAB valuation in 2011-12 should therefore be \$15,894m rather than \$15,934m.

## 4 A shorter regulatory period should be adopted

The ACCC discusses the appropriate length of the regulatory period in section 4.5.2 of the discussion paper. It proposes a five-year regulatory period, commencing on 1 July 2011.

The primary reason given by the ACCC for this period is to provide certainty during the transition to the NBN. The ACCC also notes that this regulatory period is commonly used in other industry sectors.

Our view is that this regulatory period is inappropriately long in the current circumstances. In this section of our report, we will explain that:

- The ACCC has not accurately captured the primary issues that we have already raised with such a long regulatory period, which relates to the uncertainty about the quality of forecasting and the opportunities this raised for excess profits to be earned.
- There is a significant disconnection between the forecasting and cost assessment standards adopted for future regulatory resets and those applied in the current final determination process.
- Significant weaknesses and uncertainties with various forecasts remain, which substantially increase the risk associated with a lengthy regulatory period
- It is not possible to promote certainty for a period that is longer than the declaration terms for the fixed services. This is because the declarations expire in 3 years but the industry does not know whether the services are to be re-declared or not
- There are other options available to the ACCC that would minimise uncertainty while allowing for a shorter regulatory period, and this would be in the LTIE.

### 4.1 The ACCC has not understood the concerns with a 5 year regulatory period

In section 4.5.2, the ACCC notes that Frontier has previously argued that a two-year regulatory period would be appropriate, with longer periods to follow after the initial period. This accurately reflects what we said. However, the ACCC then suggests that we were concerned that the lengthy regulatory period was not appropriate because “forecasts were not available for that period”. This misunderstands our objections to five years, which were that:



- the ACCC, in the face of uncertainty about costs, had been generous to Telstra in forecasting capital and operational expenditure, and in rounding up prices beyond the levels that its costs estimates would indicate.
- That there were alternatives that the ACCC should have considered in getting the balance right between encouraging efficient expenditure and protecting the interests of end-users, including shortening the initial regulatory period.

We recognised that shortening the regulatory period might dull incentives for improved efficiency (and reduce certainty). However, it would mitigate the impact of inaccurate forecasting that could allow Telstra to extract rents from consumers, and deliver gains to access seekers and consumers earlier than otherwise.

In our view, there is little that has changed from the September 2010 consultation until now that reduces the risk that costs will be inaccurately forecast. Telstra's forecasts have not been 'road tested' against actual outcomes. Further, significant uncertainty still remains about how any proposed deal between Telstra and NBN Co might be resolved. If this results in payments for services between NBN Co and Telstra this will need to be factored into any wholesale pricing arrangements, yet it is not clear how the ACCC proposes to address this.

## **4.2 The ACCC does not appear to meet its own criteria on forecasting transparency**

### **4.2.1 Capital expenditure**

A curious feature of the ACCC's discussion paper is that it outlines some important criteria for forecasting in future regulatory periods, but does not require these criteria to be met for the first regulatory period.

Capital expenditure is dealt with at Section 6.2.5 of the discussion paper. There is a discussion of efficiency mechanisms which correctly identifies that efficiency mechanisms give Telstra incentives to overstate its estimated expenditures, in order to reap the benefits of 'efficiency improvements'. However, the ACCC proposes certain mitigation strategies to deal with this problem:

While the ACCC recognises that Telstra has incentives to overstate its required expenditures, it considers this will be mitigated by requiring it to:

- provide a detailed explanation of the information, assumptions and cost drivers used to develop its forecasts for the coming regulatory period—and subjecting this explanation to scrutiny during the consultation process for the price reset, and
- explain any significant differences between its forecasts for the previous regulatory period and its actual capital expenditure over the period.

In future price resets, to assess the prudence and efficiency of Telstra's capital expenditure forecasts, the ACCC will analyse, and consult publicly on (while appropriately protecting Telstra's commercial-in-confidence information), the supporting information provided by Telstra on its forecast 'baseline' and discretionary projects. This supporting information should include:

- a copy of Telstra's internal investment guidelines used to rank capital expenditure projects
- an explanation of the assumptions used to determine total capital expenditure including:
  - o how the 'baseline' capital expenditure forecasts relate to the drivers of investment, such as population growth and replacement of assets nearing the end of their asset lives
  - o for discretionary projects, a broad description of the type of investments being undertaken and the drivers of those investments.

In submitting capital expenditure forecasts for each regulatory period, the ACCC proposes that Telstra should provide:

- a report comparing the forecast for the previous regulatory period with actual capital expenditure, and
- an explanation for any differences.

We agree with the ACCC that these are helpful and useful measures. It is concerning, however, that many of these requirements and mitigation strategies do not seem to apply to the first (current) regulatory process. For example, we have not seen (and assume the ACCC has not seen) any documents relating to internal investment guidelines, or Telstra reports comparing forecasts with actual variables in previous years and explanations of any divergences. Further, we note that:

- Telstra has not provided forecasts for indirect capital assets, which accounts for [c-i-c] of total capital expenditure in 2015/16 ("Telstra's updated forecasts did not include capital expenditure on 'indirect capital assets'", p. 79).
- Telstra did not provide an explanation of how it had allocated forecast total capital expenditure to asset classes (p. 81).
- There is no detail about whether the ACCC will undertake prudency checks, monitor the use of a competitive tender process, or will allow cost pass-throughs in certain circumstances (see list on p. 74).
- There was a substantial fall in capital expenditure forecasts between the September 2010 ACCC position and the current position (from around [c-i-c] to just under [c-i-c] each year). Further, there have been revisions upwards in capital expenditure (by [c-i-c] million) by Telstra between the recent IAD and draft FAD determinations. These large variations provide little confidence that the ACCC has 'got it right this time'.

Given these facts, we are surprised that the ACCC has such confidence in the forecasts that it would be preferable to lock prices in for five years.

#### 4.2.2 Operating expenditure

Forecasts for operating costs are subject to similar criticisms as for capital expenditures. While we appreciate that the ACCC has undertaken a much more extensive review of these costs, we note that:

- Telstra has not provided any operating expenditure forecasts specifically related to the CAN and core networks (p. 111).
- Telstra has provided no substantive justification for the [c-i-c] increase in costs forecast across *all* of its services for the 5 years to 2015-2016 (p.111).
- There is no information as to how the ACCC has determined that ‘Project New’ will be more likely to impact on indirect, rather than indirect, operating costs: this is merely ‘assumed’ (p. 114).
- We have no detailed breakdown of operating expenditure categories and little idea of the relative importance of different kinds of operating costs, such as labour or equipment costs, and the likely change in these over time (including both quantities and prices for labour and equipment).
- Total fixed line revenues are declining<sup>23</sup>, and this would imply that Telstra needs to have a very sharp focus on reducing operating costs to avoid future price rises.

#### ***The approach to estimating indirect operating expenditure is not transparent***

The size of the mark-ups for indirect operating expenses remains (at 80 per cent) at an extraordinarily high level. In dollar terms, this equates to over [c-i-c] million of annual expenditure over which there is very little transparency: we do not know with great confidence exactly which costs this revenue is designed to recover, or on what basis the expenditures are allocated between fixed line and other services.

Further, we are not convinced that the Analysys estimate of indirect costs is a “lower bound” as described. Our review of the Analysys model documentation<sup>24</sup> suggests that Analysys did not undertake any ‘optimisation’ of these costs, as suggested by the ACCC. Rather, Analysys says that it “calculated the appropriate level of business overheads for the model using Telstra’s RAF CCA submission

<sup>23</sup> Telstra annual report 2009/10, p. 11.

<sup>24</sup> Analysys, *Fixed LRIC cost model documentation*, 17 December 2008

data from the Reporting Period June 2007”.<sup>25</sup> Adjustments were made to this data to exclude services that were not relevant to the fixed line services that were being modelled. This should also be germane here. We are therefore uncertain why the Analysys result is so different to the ACCC’s finding of a 100 per cent markup from its own analysis of the RAF data.

In fact, the 60% markup over direct operating costs may be too high. If both direct and indirect costs were ‘optimised’ by Analysys, then the *percentage* markup for indirect costs need be no higher if the direct costs are actual cost estimates.<sup>26</sup> It is true that if estimates of actual indirect costs were to be set using a markup over optimised direct operating costs, then the markup may need to be higher. However, the calculated Analysys model markup for indirect operating costs of 60% is based on actual indirect operating cost information from the RAF. Using this percentage markup on actual costs is likely to give an indirect cost estimate that is too high rather than too low.<sup>27</sup> That is, the markup on actual direct operating costs should be lower if the indirect operating costs in the optimised Analysys model are derived from actual cost data.

Again, these facts and analyses seem at odds with the ACCC’s principles / mitigation strategies set out in 7.3.4 (similar to 6.2.5). The ACCC re-iterates earlier statements that scope to inflate expenditure forecasts would be mitigated by detailed explanations of assumptions and cost drivers. As it stands, access seekers have very little information on which to make submissions here.

It may be helpful to visualise the size of the uncertainty that exists. In Figure 1, we illustrate how the ACCC’s latest forecasts have changed compared to the forecasts used in September last year. We observe that while the overall pattern is of a decline in the forecasts, there have been large increases in ‘indirect’ costs, which are not causally related to the provision of the fixed line services, and very large decreases in direct costs. Changes of this magnitude do not inspire confidence that actual expenditures will be close to the forecasts.

Figure 1: Changes in Opex and Capex forecasts, September 2010 – April 2011

[c-i-c]

<sup>25</sup> *ibid.*

<sup>26</sup> Suppose the optimised direct costs were \$80, and the markup is 100%. The (optimised) indirect costs would be \$80). If actual direct costs are used (\$100), and the same markup, then the indirect costs would also be ‘unoptimised’ (\$100).

<sup>27</sup> Suppose that the calculated markup is based on optimised direct costs but actual indirect costs. Then if the optimised costs were \$80, and the actual indirect costs were \$100, the markup would need to be 125%. But applying this markup to actual direct costs of \$100 would give a dollar markup of \$125.

Source: Frontier analysis of September 2010 and April 2011 BBMs

### **Past operating expenditure should be indexed using an import index**

For the core network, the ACCC uses a five year average of recent actual direct operating expenditure to forecast future annual direct operating expenditure. Historic costs incurred are converted to 2009-10 dollars using a price index.

As a result of our submission on the September 2010 Draft Report, the ACCC has reconsidered the index used for the equipment component of past annual direct operating expenditure in order to inflate this to 2009-10 dollars.

However, rather than adopt the price index we suggested, namely the ABS import price index for telecommunications equipment, the ACCC has adopted instead the ABS producer price index (output basis) for communications equipment manufacturing. The adoption of this index means that past expenditure is less inflated than with the use of the ACCC's previous equipment index, but not to the extent that would occur with the use of the import price index (which actually serves to deflate most past annual expenditure). The impact on forecasts is non-trivial, with the use of the ABS producer price index rather than the import price index potentially adding around \$50 million per annum to direct core network forecast operating expenditure plus a flow on effect of around \$40 million in annual indirect operating expenditure. This increases the PSTN OTA price in 2011-12 and on average over the 5 years of the FAD by 0.1 cent. It also means that LCS prices are higher by around 0.4 cents per call in each year.

The ACCC's reason for selecting the ABS producer price index over the ABS import price index and the producer price index it previously used is that these indexes are considered to be too broad. Specifically, the ACCC claims they include some non-telecommunications equipment. In the case of the import price index, the ACCC suggest that it includes sound producing and recording equipment.<sup>28</sup> While the relevant Standard International Trade Classification (SITC) to which this index is aligned does include such non-telecommunications equipment, we have been informed by the ABS (and notified the ACCC of this previously) that the index itself relates only to the capital good components (or more accurately intermediate goods) of this classification. As a result of this, most of the sound recording and producing equipment components are classified as final consumer goods and are excluded.

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<sup>28</sup> Discussion paper, p. 113.

In any event, the criticism the ACCC makes of the import price index also applies to its preferred index. The ANZIC code to which this index relates includes items such as radio broadcast studio equipment, alarm system equipment, television antenna or parts and television studio equipment. Further, many of the communications equipment items included are customer equipment such as telephones and modems, that are not part of the declared services.<sup>29</sup>

These issues are not going to be of major concern if the equipment included can be considered a good proxy for the relevant communications equipment or the irrelevant goods account for only a relatively small share of the index. Ultimately, we consider the telecommunications import price index to be superior on this basis and on the expectation that the vast majority of telecommunications equipment for the core network (such as switches and transmission equipment and its component parts) is imported.

One final point is that ACCC states that it has indexed operating expenditure for 2009-10 back to 1 July 2009. This is not necessary. Operating expenditure is a flow that occurs over the year, and we understand that previous year's indexing is based on values of the relevant indexes that are averaged within each year.

### 4.3 The proposed incentive mechanisms are not appropriate for a five year regulatory period

We noted in our previous report that<sup>30</sup>:

- incentive mechanisms are a normal and accepted part of building block models, because they provide incentives to increase efficiency and, over time, improve the process of regulatory reporting.
- incentive schemes can vary from low powered schemes, where only a small proportion of cost savings is kept, to high powered schemes, where most cost savings are kept indefinitely by the access provider.
- the roll-forward mechanisms between regulatory periods play a very important incentive role in a building block model, because they represent the opportunity for the regulator to consider how to distribute efficiency gains between the access provider and access seekers / consumers.

<sup>29</sup> ABS and Statistics New Zealand, 2006, *Australian and New Zealand Standard Industrial Classification (ANZIC)*, Cat. No. 1292.0, p. 184, [http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/0/10AD7A6DDB4190BFCA257122001ACD9E/\\$File/12920\\_2006.pdf](http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/0/10AD7A6DDB4190BFCA257122001ACD9E/$File/12920_2006.pdf)

<sup>30</sup> Frontier Economics, Submission on the ACCC's draft report - Review of fixed line pricing principles, October 2010, available at: <http://www.accc.gov.au/content/item.phtml?itemId=953680&nodeId=12563ba24288a3c7a95cfc8d75fd2d56&fn=Submission%20from%20ACCC.pdf>

- the ACCC appears to be proposing a relatively high powered incentive scheme, whereby:
  - all Opex underspend can be kept by the access provider in the current regulatory period. In the next regulatory period, Opex forecasts are likely to be reduced, which provides a limit on how long the gains can be kept.
  - the RAB will be rolled forward on the basis that the forecast Capex was actually spent, meaning that the full amount of Capex reduction compared to forecast is permanently kept by the access provider. That is, if Capex is below forecast, then depreciation allowances in future periods will allow for the recovery of costs not actually incurred.
- This high powered scheme is inappropriate for a new regime with highly uncertain forecasts of efficient level of operating and capital expenditure
- Alternative schemes are available, including rolling forward *actual* capital costs and *actual* depreciation into the next regulatory period rather than *forecast* costs and depreciation<sup>31</sup>, or sliding scale regulation, which would preserve incentives but lessen their strength because a higher proportion of gains would be shared with consumers.

From our reading of the discussion paper, it does not appear that the ACCC has given these concerns further thought. The ACCC says in relation to capital expenditure that: “efficiency improvements during previous regulatory periods would be taken into account in determining an efficient level of forecast

<sup>31</sup> This can be illustrated with an example as follows: in the first regulatory period, the service provider underspends on capex, and this leads to forecast depreciation being higher than actual depreciation. If the service provider is allowed to roll forward into period 2 the forecast capex, plus the forecast depreciation (where this will also be higher than actual depreciation of assets) then the new opening RAB will be 950. Alternatively, an actual cost approach would require that forecast depreciation and actual capex would be rolled forward. The middle ground is to roll forward actual capex and actual depreciation, which means there is a within period benefit but that this does not extend beyond the first regulatory period.

Period 1		
Opening RAB	(1)	1000
Forecast capex	(2)	100
Forecast depreciation	(3)	150
Actual capex	(4)	80
Actual depreciation	(5)	140
Period 2		
Opening RAB - high powered	(1)+(2)-(3)	950
Opening RAB - lower powered	(1)+(4)-(5)	940
Opening RAB - Actual cost	(1)+(4)-(3)	930

expenditure for the period” (p. 82). No ‘unders or overs’ are proposed, which would be an alternative way of keeping prices closer to actual costs (while losing some power in the incentive regime).

We re-iterate our previous views that the incentive regime proposed is simply too high-powered given the long regulatory period and uncertainty around key forecasts. If the ACCC is unwilling to settle for a short regulatory period, it should consider the need for a less high powered incentive scheme: one that would share a greater proportion of gains with consumers.

#### **4.4 Can certainty really be promoted when the declaration lapses in 3 years?**

The primary reason given by the ACCC for the five year regulatory period is to provide certainty during the transition to the NBN. The ACCC also notes that this regulatory period is commonly used in other industry sectors.

Even putting to one side our other arguments about why such certainty comes at a very high cost, it is questionable that the ACCC can credibly promise to deliver certainty for five years when the declarations for the fixed services run out in three years. Essentially, the ACCC seems to be promising that it will be extending the declarations, even if changes occur such that the current declarations are no longer appropriate. In this respect, it appears that the ACCC is using the access determination power where it would be more appropriate to use fixed principles to provide for the requisite degree of certainty.

#### **4.5 Adopting fixed principles will reduce the risks of a shorter regulatory period**

The ACCC discusses the use of fixed principles in Section 25 of the discussion paper. It notes that “Fixed principles promote regulatory certainty and may provide greater price stability” (p. 254). We agree with that sentiment. It provides a strong reason for why adopting a shorter regulatory period would not create an unacceptable degree of uncertainty. We therefore find it surprising that the ACCC does not consider fixed principles and a shorter regulatory period to be an effective substitute for a longer regulatory period.

The ACCC proposes fixed principles on:

- locking in the RAB
- the RAB roll forward approach
- how to forecast service demand, operating and capital expenditure
- how the WACC should be estimated



- cost allocation

Fixed principles that deal with these issues will tightly constrain the issues that are debated at a regulatory reset, and it is therefore difficult to see where a material level of uncertainty would come in at the regulatory review period.

If fixed principles are introduced, then we consider that the balance here clearly favours a shorter regulatory period. If revised and updated forecasts reflect materially better information on Telstra's costs and demands (including better knowledge about the deal with NBN Co and the de-commissioning of the copper network) then that is a material benefit that would not be captured under a five year period.

We therefore re-iterate our position that there should be a two-year period, or, at the outside, a three-year period. A three year period would also have the nice feature of being compatible with the declaration period.

## 5 Averaging of PSTN OTA charges would not be in the LTIE

We have a number of concerns with the ACCC's proposal in its discussion paper to abandon the longstanding practice of specifying PSTN OTA charges on a geographically differentiated basis in favour of a geographically uniform charge:

- the ACCC's reasoning that an average charge might be adopted in the FAD in preference to geographically differentiated charge is flawed
- the ACCC's idea that an average charge could be used as a basis for access seekers to negotiate acceptable de-averaged charges with Telstra is unrealistic.

The LTIE would be better served by specifying geographically differentiated charges.

### 5.1 Why geographically differentiated charges are in the LTIE

We find it puzzling that the ACCC could find that a geographically averaged charge for PSTN OTA was in the LTIE. It has historically taken the view in all previous decisions on these charges that geographically differentiated charges were in the LTIE. It does not cite any change in circumstances that would cause it to change its mind. It seems the ACCC's reasoning is primarily driven by SingTel Optus' preference for an averaged charge, given it stands to benefit from a lower charge due to a calling profile that is more centred on regional areas than the overall average.<sup>32</sup>

The ACCC uses information it has collected that indicates few other countries use explicit geographic-based charging for interconnection charges as part of its reasoning for adopting an average national charge. This is notwithstanding that nearly all of the cited countries have routing or switching (i.e. element) based charges that will lead to different geographic based-charges if the use of such elements differ depending on the location of the fixed customer relative to the point of interconnect (POI). For example, many European countries have 'local', 'transit' and 'double transit' interconnection charges. The ACCC does not consider the possibility that these could serve as a proxy for geographic charging.

The ACCC also seems to have overlooked the following reasons why geographically differentiated charges will be in the LTIE:

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<sup>32</sup> ACCC Discussion Paper, p. 146.

- *Differentiated charges promote competition:*
  - There are no retail charge controls that stop retail calls that use PSTN OTA services from being geographically differentiated, unlike for retail local call and voice line rental services. This means there is no possibility that price squeezes could be imposed in regional and rural areas driven by different price structures for wholesale and retail services. In contrast, averaged charges could deter efficient competition in lower-cost areas and encourage inefficient competition in higher cost areas.
  - Differentiated charges will mean that access seekers face the same costs structure that Telstra faces. This will ensure that those carriers or carriage service providers that are the most efficient in providing downstream services will have the opportunity to win the customer. This is particularly important in Australia where the costs of serving rural customers can be many times greater than the costs of servicing urban based customers due to higher infrastructure costs and much thinner volumes over which to spread these costs. We note too that Telstra's long-distance retail charging structure includes some variation in charges by distance, with charges becoming progressively greater over distances up to 50km, 50-85km and above 85km.<sup>33</sup>
  
- *Differentiated charges promote efficient investment and use of infrastructure*
  - This follows in a straightforward way from the analysis of the Australian Competition Tribunal in *Re: Telstra Corp* (2007).
  - The Tribunal found that *efficient investment* would occur when access charges were set to ensure recovery of the efficient costs of investment, and that while averaging might not discourage efficient investment by Telstra, it would discourage efficient investment by access seekers (because their input costs would be distorted).
  - The Tribunal found that *efficient use* would not occur under averaging because the disassociation of prices and costs it would discourage allocative efficiency.
  - To the extent that there are material differences between prices and costs for PSTN OTA services in different geographic areas – which we believe there are – then the ACCC has not explained why it thinks that averaging these prices could promote efficient investment or efficient use of infrastructure, or that any detriments from geographic differentiation

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<sup>33</sup> See [http://telstra.com.au/homephone/call\\_types\\_rates/std\\_calls.html](http://telstra.com.au/homephone/call_types_rates/std_calls.html), accessed 16 May 2011.

would be outweighed by other advantages which would mean that it is in the LTIE.

Further, the extent that the ACCC now views price stability as an important criterion under s 152BCA then it would also favour continuation of de-averaged charges.

## 5.2 Unrealistic to expect access seekers to negotiate acceptable geographically differentiated charges

In part, the ACCC seems to base its acceptance of geographic averaging on the view that it would not necessarily be binding on access seekers, who could negotiate different terms if that were to be advantageous. However, the ACCC does not appear to consider that for any negotiation to take place, the different term must be mutually advantageous. As it stands, it seems fanciful to expect that access seekers who primarily acquire PSTN OTA in lower cost areas (CBD and Metropolitan) would be able to negotiate geographically differentiated charges with Telstra, as this will mean that the quantum of charges paid to Telstra will be lower. That is, given the geographically averaged charge will lead to higher OTA prices for CBD and metropolitan areas, why would Telstra agree to charge access seekers a lower charge in these areas?

Of course, this argument that there will be no effective negotiation also holds in higher cost areas, except in this case it will be the access seeker who will be unwilling to negotiate. An access seeker would only seek to negotiate a different charging structure with Telstra if its average cost of using PSTN OTA was less than 1 cent averaged charge. An access seeker with a traffic profile that favours higher cost areas will have no incentive to seek a deal with Telstra.

One lesson from the last 14 years of telecommunications regulation in Australia, is that the negotiate-arbitrate model has been a spectacular failure for fixed services. Indeed, that is why the regulatory framework now includes FADs so that the ACCC can specify up-front price terms and conditions. To think that access seekers will be able to negotiate geographically differentiated charges that are below the geographically averaged charge ignores the history of negotiated outcomes under the previous regulatory regime.

## 5.3 Optimised models not suitable for setting differentiated charges

In abandoning its approach of setting access prices on a the basis of optimised forward looking costs, the use of optimised costs differentials for setting geographically differentiated charges could be problematic. We expect that this is part of the reason why the ACCC has gone cold on the idea of setting charges on

this basis. Ultimately, however, this is a poor reason not to adopt differentiated charges and the ACCC could for example, estimate these cost differentials from older optimised models that more closely reflect Telstra's actual network (as it has done to date using the PIEII model cost differentials) or try and estimate them directly from Telstra's actual cost and traffic data.

## 6 Cost allocation and other price setting issues

### 6.1 Cost allocations

We appreciate the ACCC's efforts since the September 2010 draft report to increase the level of transparency with respect to its adjustments to the cost allocation factors taken from the Analysys model that are used to allocate costs between the regulated fixed services and Telstra's other services. We also acknowledge that it has addressed a number of the issues we raised with respect to the cost allocations in our submission to the September report. Nevertheless, we have some residual concerns which we outline below.

#### 6.1.1 Data traffic growth rates

Data growth rates are used as an input to re-base the Analysys model's allocation factors for transmission equipment. High data growth rates relative to call volume growth rates serve to reduce the allocation of the cost of this equipment to the declared PSTN OTA and LCS services. As we argued in our previous submission and in the section below, adjustments should also be made to the allocation factors for inter-exchange cable allocation factors to account for data traffic growth.

The ACCC has assumed that data growth on the fixed network will be 20% on the previous year for the years 2010-11 to 2015-16. This is despite an actual growth figure used (based on ABS data) of 57% between the years 2008-09 and 2009-10.<sup>34</sup> It is surprising that the ACCC has taken the view that annual data growth will decline to 20% per annum, particularly as it has provided no justification for this magnitude of decline in the level of growth. We note that Cisco has recently released its projection of IP traffic growth for Australia based on its Visual Networking Index that forecasts a compound annual growth rate of 41% over the period 2010 to 2015.<sup>35</sup>

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<sup>34</sup> ACCC discussion paper, p. 131 and ACCC Fixed Line Services Access Pricing Model, 20 April 2011 (Confidential Version), Worksheet E.

<sup>35</sup> See [http://www.cisco.com/web/solutions/sp/vni/vni\\_forecast\\_highlights/index.html#~Country](http://www.cisco.com/web/solutions/sp/vni/vni_forecast_highlights/index.html#~Country).

### 6.1.2 Allocation factors for inter-exchange cables

We are astonished that the ACCC has not deemed it necessary to adjust the allocation factors for interexchange cables to take account of past and future data traffic growth in the same way that it does for transmission equipment.

While the ACCC has acknowledged our previous submission on this issue, the reason it gives for not making the adjustment is effusive and unconvincing. It claims that the asset values for this asset class in Telstra's RAF accounts shows a decline since 2002-03 despite significant growth in data traffic and that 'an adjustment...is not justified on the basis of the available information'.<sup>36</sup>

In response to this, it is not clear to us why falling or increasing asset values has anything to do with not making such an adjustment. In the case of fibre optic links which would clearly be the major component of this asset class, enormous increases in traffic can be accommodated without installing more fibre. The cost of the existing asset will simply be spread across a higher volume of traffic.

As a consequence of not making the adjustment for data traffic growth assumed by the ACCC, the PSTN OTA and LCS allocation factors for inter-exchange cables are likely to be too high to begin with ([c-i-c]), and only fall from [c-i-c] respectively in 2011-12 to [c-i-c] respectively in 2015-16. By contrast the allocation factors for PSTN OTA and LCS for transmission equipment commence at [c-i-c] respectively in 2009-10 (already adjusted for increased data traffic growth to this period) and become [c-i-c] respectively in 2011-12 and [c-i-c] respectively in 2015-16.

## 6.2 Rounding and smoothing of prices

The ACCC decided to both round up and smooth prices estimated by the FLSM for key services for the IAD. It now proposes to smooth but not round these prices, so that a single, average price will persist over the 5 year FAD period.

We strongly support the ACCC's decision to not round up prices, for obvious reasons.

We consider that the reasons the ACCC provides for smoothing prices do have some merit. Where intra-period deviations are small, and inter-period changes in prices are highly unknown, then there may be little value in changing the prices. However, we would note that setting a price path that does not smooth is no less certain than one that does smooth, and, to the extent that the final year price is a

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<sup>36</sup> ACCC Discussion paper, p. 131.

more accurate reflection of the likely price in the first year of the new regulatory period, it would be preferable to adopt a price path.

### 6.3 The treatment of LSS

We support the ACCC's change to the treatment of LSS services. Bringing them within the FLSM increases the consistency of treatment of LSS and other fixed line services.

Nonetheless, we are concerned by the ACCC's statement that it "has been unable to assess the reasonableness of these estimates [of costs] as Telstra did not provide detailed information on how these costs were calculated." (p. 156) Presumably, this is because the LSS does not appear as a wholesale service in the RAF: Telstra notes that it appears as one of the services under "Other External Wholesale Services".<sup>37</sup>

It is incongruous for a regulator to say it is unable to assess the reasonableness of data given to it, but then proceed to use that data to set access prices for a regulated service. If a decision maker cannot be convinced of the reasonableness of data before it, it should not use that data to set prices for a regulated service.

As we have argued in the previous section of this report, this also does not inspire a great deal of confidence that the prices set are likely to be appropriate for a five year period.

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<sup>37</sup> Letter from Telstra to the ACCC dated 20 November 2011, p. 36.



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