



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

SCHEDULE A.2: RESPONSE TO CEG ASSET VALUATION ANALYSIS

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1. INTRODUCTION

1. The Competition Economists Group (**CEG**) on behalf of Optus has proposed an alternative means of valuing Telstra's regulatory asset.¹
2. CEG observe that RAF values "do not represent a useful number to establish an initial RAB for Telstra's CAN", because:²
 - the sum of historic costs is unlikely to be adjusted for inflation and will therefore be lower than it should be once inflation on the historic costs have been considered; and
 - the depreciated historic costs recorded in the RAF 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.
3. However, CEG's approach to determining an asset value which does take into account historic compensation is deeply flawed. The remainder of this schedule addresses each of the flaws in the CEG approach.

2. CEG'S STARTING PREMISE FOR VALUATION IS WRONG

4. The fundamental and incorrect premise of CEG's report is that, but for the legitimate interests of the access provider, the long term interests of end users are promoted when sunk costs are valued at zero.³ This is a misinterpretation of the relevant criteria in the *Competition and Consumer Act 2010* and is inconsistent with all relevant precedent.⁴
5. The recovery of the value of sunk investments is critical for promoting the long term interests of end users.
6. Most importantly, the treatment of sunk costs will affect incentives for efficient use of and investment in infrastructure, which is critical to the long-term interests of end users.⁵ Failure to allow the recovery of past sunk costs creates an expectation for the treatment of such costs in future, and thereby creates a disincentive to invest in sunk infrastructure. Similarly, substantial devaluations of sunk assets or the stranding of depreciation would set a clear expectation to the owner of those assets that such devaluations can be expected in the future.
7. This point has been recognised by the Commission⁶ and was also recognised by the Australian Competition Tribunal in *Re Seven Network*:⁷

It is always the case that once an investment is made and sunk (it cannot be undone and the money recovered by selling the infrastructure as 'parts' or scrap), it is unnecessary - strictly speaking - to charge anything more than marginal cost to ensure the investor stays in business. After all, the investor is better off receiving its marginal costs rather than closing down. Such an approach, however, disregards the signals sent to other prospective investors who, if observing enforced marginal-cost pricing, are less likely to invest in the future.

¹ CEG, *Past cost recovery and asset valuation: A report for Optus*, March 2010 (**CEG Report**)

² CEG Report, paragraph 91.

³ CEG Report, sections 2.2 and 2.3.

⁴ For example, *Re Seven Network*, footnote 7 below.

⁵ CCA, s152AB(2)(e).

⁶ ACCC Discussion Paper, p 54.

⁷ *Re Seven Network Limited (No 4)* [2004] ACompT 11, at [136].

8. Moreover, not allowing for recovery of the value of sunk investments will not promote competition. In assessing whether a particular thing is likely to promote competition over the long run (and thereby promote the LTIE), regard must be had to the extent to which the thing, recovery of sunk investments in this case, will remove obstacles to end users gaining access to listed services.⁸ The fixed services are provided over infrastructure that is to a large extent sunk, and the supply of fixed services has and continues to require significant ongoing investment.⁹ Quite simply, without past or future investment in copper cables, pit and pipe and other critical infrastructure, Telstra would be incapable of providing fixed services to end users. Establishing a regime that provided no incentive for an access provider to invest in sunk assets, would be an obstacle that prevented end users from gaining access to the fixed services.
9. CEG also suggest promotion of competition requires a form of competitive neutrality, although CEG fail to recognise this in their conclusion on the promotion of competition criterion. CEG argue that competition is promoted when the access provider recovers its actually incurred past and future costs, presumably including sunk costs, from its retail customers and access seekers.¹⁰

3. CEG'S VALUATIONS ARE FLAWED

10. CEG accepts that Telstra has a legitimate business interest in recovering the value of its sunk investments. However, CEG acknowledges their own difficulty in attributing a value to those investments.¹¹ Indeed, CEG has not accurately attributed a value to Telstra's past investments at all.
11. CEG proposes a number of alternative approaches to valuation, each of which is deeply flawed.
12. First, CEG attempts to estimate DORC, but in a way inconsistent with the history of regulation or investors' expectations. The inconsistency comes from the subtraction of a "service quality adjustment" from the DORC valuation. This is inappropriate for the following reasons:
 - The higher "service quality" arises from CEG's assumption that the optimal network is a fibre network, but CEG demonstrate that the investment in such a fibre network would cost more than the benefits of that investment. Hence, the higher "service quality" assumed is unattainable in the competitive market framework set out by CEG.¹²
 - The "service quality" adjustment has never been applied by the ACCC in any of its pricing determinations based on TSLRIC (or other) pricing principles. The adjustment has also been dismissed by the Australian Competition Tribunal.¹³
 - The "service quality" adjustment that CEG propose is similar to an argument that depreciation should be accelerated to account for future technology. However, the past application of TSLRIC and tilted annuity, heavily back-loaded depreciation. Introducing a "service quality" adjustment after more than 10 years of TSLRIC and tilted annuity, which involves arbitrarily subtracting an amount from the value of the asset, means part of the backloaded and yet to be recovered depreciation would simply be subtracted undermining the expectation of cost recovery. If there had been an

⁸ CCA, s152AB(4).

⁹ As noted in section 2.1.4 of Telstra's submission, a significant proportion of Telstra's current fixed line assets have deployed relatively recently.

¹⁰ CEG Report, paragraph 38.

¹¹ CEG Report, paragraph 33.

¹² CEG, section 3.2.1.

¹³ *Application by Telstra Corporation Limited* [2010] ACompT 1, at [223]-[227].

expectation of fibre becoming a more efficient technology than copper, then the previous depreciation of the asset base should have been accelerated by the ACCC to allow cost recovery.

13. Second, CEG calculates a value of the CAN of \$10B, based on the value attributed to Telstra at privatisation in the same year of \$42B.¹⁴ However there is no detail or transparency as to how CEG has calculated this figure, and accordingly it can be afforded little weight.
14. Third, CEG calculates a value of Telstra's assets based on the NERA model.¹⁵ They state that NERA valued Telstra's CAN at \$16.3B in 1998, and add to this \$1.7B in what CEG describe as "future replacement capex", but do not detail. CEG then subtract from this the present value of Telstra's capex, which CEG claims amounts to \$7.5B in present value terms. The difference between these amounts, \$10.5B, is claimed to be a valuation of Telstra's CAN. Telstra has several concerns with this approach:
 - It is not clear that figures are converted into present values to the same year. If not, they cannot be compared.
 - Telstra's past capex is incremental to the capital base prior to 1998. It is not clear how this can be subtracted from a valuation of all capital arising from the NERA model. If anything, post 1998 capex should be added to a valuation as at 1997, and depreciation subtracted.
 - The other inputs into this calculation are not set out and cannot be verified.
15. Finally, CEG estimate a DHC valuation ranging from \$9.1B to \$10.1B in 1997 dollars.¹⁶ Putting to one side the difficulties with adopting a DHC approach (set out in section 2.1 of Telstra's submission), the additional point to note about CEG's analysis is that the 1997 valuation would need to be converted into 2009 dollars. The 2008 value that CEG arrives at ranges from \$11.9B to \$13.3B¹⁷, both higher than the ACCC's estimate of \$9.8B.
16. CEG develop a rudimentary roll forward model to convert the value of the assets in 1997 to their value in 2010. Their analysis has several problems, including:
 - They have not calculated depreciation by means of either accounting depreciation or the depreciation allowed by the ACCC as a result of its implementation of regulation from 1997 to 2010;
 - CEG take no account of indirect capital and opex, which fixed services must make a contribution to;
 - The WACC used by CEG is calculated on a bottom-up basis using parameters that do not reflect Telstra's actual cost of debt nor return to equity holders;
 - CEG's revenue figures include revenue from services that are not regulated (e.g. ISDN);
 - CEG ignores that Telstra must recover retailing costs for the vast majority of lines;¹⁸

¹⁴ CEG, section 3.3.1.

¹⁵ CEG, section 3.3.2.

¹⁶ CEG, paragraph 97.

¹⁷ CEG, paragraph 94.

¹⁸ CEG argue this because imputation test margins on its access services, not counting retail costs might not be negative. Telstra's imputation tests report the margin for access and local calls combined – CEG do not take local calls into account in their analysis. Even if the imputation test margin on access was negative, this would not remove the fact that Telstra would need to recover those costs.

- CEG assumed that Telstra has not earned any normal commercial retail profits – in effect they suggest that any retail profits that were earned in competitive retail markets, should be taken off the value of assets used to determine wholesale price for Optus;
 - CEG 's operating expenditure assumptions are incorrect; and,
 - It is not clear whether CEG has treated real and nominal values consistently, or whether the value that CEG arrives at is in 2009 dollars as the ACCCs' FLSM requires.
17. CEG does not set out any of their calculations and there could be numerous errors that would become identifiable should that analysis become transparent. In any case, CEG's approach is to unwind almost a decade of regulation and the effect that regulation has had on asset values and prices, to assume that regulation never happened or should never have happened.
18. Telstra submits that none of the valuations put forward by CEG should be given any weight in light of the material deficiencies outlined above.

4. CEG PLACES AN IMPORTANT CAVEAT ON THEIR VALUATIONS

19. The basis for CEG's choice of valuation methodologies is the old Gas Code, which sets out a range of methodologies which may be used by regulators to establish a value for the initial asset base.¹⁹
20. However CEG note an important distinction between the context for asset base valuation under the Gas Code and the current situation:²⁰

... a potentially important distinction between the context of the gas industry and the current context is that existing gas pipelines regulated and valued under the Gas Code were by and large being regulated for the first time. In contrast, fixed line telecommunications infrastructure has been regulated by the ACCC (and at the retail level by the Government) for more than 10 years (since 1997 the ACCC has regulated access under Part XIC).

*During this period, regulated prices have been set for services provided by the fixed line telecommunications network. Implicit in each of these regulated prices was a value for the assets used to provide the regulated service. **As such, determining an asset value today which is entirely inconsistent with the history of regulation and the past expectations of investors in the access provider (including the compensation they have subsequently received) may be viewed as inconsistent with the access provider's legitimate business interests** [emphasis added].*

21. This is a critical distinction which the Commission fails to recognise in its Discussion Paper. Given the history of telecommunications regulation, the asset valuation exercise cannot be undertaken in a vacuum, without proper regard to previous valuations. Determining a valuation that is inconsistent with past valuations would not be consistent with Telstra's legitimate business interests.
22. Given this caveat, the valuations put forward by CEG that are not consistent with previous regulatory practice (in particular the DHC valuations) should be disregarded entirely.
23. Telstra has proposed a valuation that is consistent with the the approach referred to by CEG, by calculating the depreciated value of Telstra's assets from the previous regime.²¹ That

¹⁹ CEG Report, paragraph 43-44

²⁰ CEG Report, paragraph 46-47

valuation is consistent with the history of regulation and is consistent with the past expectations of investors in Telstra.

²¹ Refer to sections 2.1.2 and 2.1.3 of Telstra's submission