PUBLIC VERSION OF TELSTRA'S CONFIDENTIAL SUBMISSION IN RESPONSE TO THE ANALYSYS REPORT

A INTRODUCTION

1 On 23 December 2005, Telstra gave to the Australian Competition and Consumer Commission ("**Commission**") two undertakings for the Unconditioned Local Loop Service ("**ULLS**") pursuant to section 152BS of the *Trade Practices Act 1974* ("**TPA**") ("**Undertakings**"). The ULLS Undertakings relate to the 6 month period from 1 January 2006 to 30 June 2006 and the 2006/07 and 2007/08 financial years. At the same time Telstra provided the Commission a submission in support of the ULLS Undertakings ("**the Submission**").

2 On 31 January 2006 the Commission published its discussion paper in respect of Telstra's Undertakings for ULLS ("**Discussion Paper**").

3 On 14 March 2006 Telstra provided the Commission with "Telstra's Confidential Submission in Response to the Australian Competition and Consumer Commission's Discussion Paper in respect of ULLS dated January 2006" ("**Telstra's Discussion Paper Response**").

4 On 16 June 2006 the Commission published its draft decision in respect of Telstra's Undertakings for ULLS ("**Draft Decision**").

5 In the Draft Decision, the Commission referred to a report by Analysys Consulting Limited titled "Review of specific issues in Telstra's PIE II model", dated 24 May 2006 ("**Analysys Report**").

B RELEVANT DOCUMENTS

6 Telstra relies on, and this Submission should be in read in conjunction with, the following:

(a) report of Bridger Mitchell entitled "ULLS Commentary on MJA and Analysys Submissions" ("**Mitchell Report**"); and

(b) Telstra's submission in response to the Draft Decision ("**Draft Decision Response**").

7 In this submission Telstra responds to matters raised in the Analysys Report which are not covered by the Mitchell Report and the Draft Decision Response.

C CONFIDENTIALITY

8 This submission has all of the confidential information deleted and thus may be disclosed publicly.

9 Telstra will provide this submission and the information contained in it to interested parties upon those parties signing appropriate confidentiality undertakings.

10 The confidentiality undertakings do not limit the extent to which interested parties, including the Commission, can analyse and comment on the content of this submission. Rather they are intended to prevent the distribution and use of the confidential material contained in this submission for purposes other than participating in the Commission's public inquiry relating to the Undertakings.

D. SUBMISSIONS

11 Analysys claims that the degree of trench sharing between the IEN and the CAN that is assumed in the PIE II model is set to reflect Telstra's actual deployment, which is the product of a very long history. This is incorrect. The degree of sharing is not based on the actual level of sharing within Telstra's network. Rather, the PIE II model estimates sharing between the CAN and the IEN based on the optimised network design within the PIE II model.

12 Analysys states that recent technological developments, in particular with regard to new radio systems such as WiMAX, raise the question of whether the technologies captured by the PIE II model indeed constitute relevant modern equivalent assets. Telstra relies on the statement of **[c-i-c]**, dated 3 August 2006, as to the WiMAX technology. Further, ULLS is a copper based service. Therefore, in estimating the costs of ULLS, costs of an alternate network to copper are irrelevant.

13 Analysys cites the example of aerial cable as being more expensive to maintain than buried cable thus suggesting that Telstra's O&M factors are inflated. This statement is not supported by any evidence. As noted in the Mitchell Report, the method Telstra has used to calculate O&M factors conforms to international practice.

14 Analysys states that some of the modularity of equipment assumed in the model appears unnecessarily overstated. Analysys presents no evidence or support for this general statement.

15 Analysys states that they are concerned that the roll-over of O&M costs is directly linked to the evolution of capital costs, which is simplistic and does not recognise the separate

evolution of operation and maintenance costs. As discussed in the Mitchell Report, the calculation of O&M costs in the PIE II model conforms to international practice. Even if Telstra did set different price trends for O&M than it uses for capital, this is not likely to reduce network costs. In particular, it is likely that O&M costs have increased, given increases in the cost of labour,[1] while many asset prices are assumed in the PIE II model to be decreasing over time.

16 Analysys asserts that two different sets of price trends have been presented by Telstra in the model and in the documentation supporting the Undertakings. For the purposes of the Undertakings, Telstra has provided five copies of the PIE II model to the ACCC. The base 2004/05 model did not incorporate any of the changes necessary to produce cost estimates for 2006/07 or 2007/08. The other four versions of the model were runs of the model with the inputs updated. Telstra relies on the statement of **[c-i-c]** dated 3 August 2006 in this regard.

17 Analysys states that according to Telstra the growth in the number of households in Australia is around 2% per annum, and that the recent decline in the demand for lines is not representative of the medium term outlook. However, Analysys also estimates the proportion of lines that are in new estates to be 1% in each year. Telstra relies on the statement of **[c-i-c]**, dated 21 July 2006, and submits that in light of the matters set out in that statement, the 1% estimate is overly conservative.

18 Analysys asserts that for long-lived assets such as trenches and cables, Telstra seems to have apportioned the whole of its actual O&M expenses allocated to these assets to the cost produced by the PIE II model and that the use of O&M for a mixture of technologies is inconsistent with the objective to produce a forward-looking, MEA-adjusted cost. Analysys further states that if the network produced by the model is somehow more compact, or has less network elements, than Telstra's actual network, then a portion of the O&M costs would certainly not be incurred by an efficient entrant. Analysys is mistaken. The ratio of O&M expenses is calculated by comparing the actual O&M spend from the regulatory accounts with a measure of capital for each asset. That ratio is then applied to the capital build costs of the network to determine the overall O&M for that year. Therefore, any change in the build cost of the network would indeed show up in a different O&M figure. If the model calculates lower capital costs because of less network elements then the O&M reduces in direct proportion to the reduction in capital costs.

[1] For example wage costs have increased by 18.9% over the last 4 years and by 39.3% over the last 10 years (Australian Bureau of Statistics, Wage Cost Index for Construction Sector, ABS 6345).

19 Analysys states that it is not convinced that the PIE II model is using the best cable dimensions in its rural cabling (**[c-i-c]** as a minimum). However, it is not more efficient to use cable sizes of less than **[c-i-c]**. While the upfront capital costs are higher using **[c-i-c]** cables (compared to smaller sized cables), this does not mean that overall network costs would be lower. Other relevant factors that impact cost include:

(a) ease of provisioning and integration into the network;

(b) least cost maintenance over the life time of the asset;

(c) ease of documenting and recording cable locations and sizes; and

(d) increased costs from carrying multiple cable gauges.

Constructing and maintaining a network with additional cable sizes introduces complexity into systems and processes and necessarily carries additional costs. These costs include the fact that:

(a) buying power is necessarily reduced when buying multiple sizes of cable;

(b) distribution costs are higher if all service vans and depots are required to carry additional sizes of cable, increasing handling costs and making warehouse/van storage more complex;

(c) for any given quantity of stock, increased number of cable gauges means that trucks and depots need to restock more regularly;

(d) effectively reducing the spare capacity in cables increases the probability of insufficient spare pairs to fix faults, and hence having to construct additional trench, conduit and main cable (which is a very expensive operation to undertake); and

(e) most importantly, the average cost per pair increases as the number of pairs provided in a single installation are decreased (as occurs when using multiple gauges of cable). That is, the provisioning costs of cable can be represented in the form $(A + Bp) per km where A and B are constants and p is the number of pairs. The constant “A” comprises the portion of the basic costs common to all installations irrespective of cable size. The term "Bp" allows for an incremental increase in cost proportional to the number of pairs being provided. It follows that the average cost per pair decreases as the number of pairs provided in a single installation is increased.

Analysys appears to have focused solely on upfront capital costs and has overlooked each of these other factors.

20 Analysys states that if the capital costs required to deploy the network go up over time, then the operating costs will also be modelled to go up in the same proportion. Telstra submits that this is appropriate. As discussed in the Mitchell Report, calculating O&M factors in this way conforms to international practice. In addition, Telstra submits that if capital costs increase, then it is reasonable for the costs associated with operating and maintaining that capital to increase.

D. CONCLUSION

21 For the reasons set out above, in the Mitchell Report and the Draft Decision Response, the Commission should have no regard to the views expressed by Analysys.

Dated: 21 August 2006