IT'S HOW WE CONNECT

TELSTRA CORPORATION LIMITED

Public inquiry into final access determinations for fixed line services—primary prices

Response to industry submissions

22 December 2014

Public version

IT'S HOW WE CONNECT

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Executive Summary

Telstra provided its response to the ACCC's Discussion Paper on primary price terms for the declared fixed line services on 3 October 2014.

Since that time, a number of other submissions have been made.

This submission is a response to some specific points made in submissions to the ACCC, which require clarification or correction.

This submission is accompanied by a second expert report from Mr Jeff Balchin, responding to new issues raised in submissions in relation to the cost allocation issue, and providing an assessment of the ACCC's proposal (set out in the Position Paper) to adjust the Regulated Asset Base (RAB) for decommissioned or under-utilised assets (Appendix 2).

The key points which Telstra seeks to clarify in this submission are summarised below and addressed in greater detail in the body of this submission. Responses to specific issues raised in industry submissions are set out in Appendix 1.

The ACCC's mandate is tofocus on the application of the Fixed Principles, not on delivering a particular price outcome

There is an assumption underpinning some industry submissions that access prices must be reduced. The iiNet submission is the most forthright on this point, arguing that "*an outcome where access prices are increased for legacy services is irrational*" and that the central question for this FAD inquiry should be "*by how much should access prices for the Declared Services be reduced?*".[1]

In Telstra's view, the outcome of this inquiry cannot be pre-judged by any party. The process for determining prices is clearly prescribed by the Fixed Principles, and the outcome of this process may either be an increase or a decrease in service prices, or price stability, depending on the relative changes in cost inputs and forecast demand for network services between regulatory periods.

Consistent with practice in other regulated industries, the focus of the ACCC's inquiry should be on ensuring that it properly gives effect to the applicable building block methodology – in this case as prescribed by the Fixed Principles, and determining all inputs into the methodology in accordance with those principles. The ACCC has determined (in the 2011 FADs) that applying a building block methodology to determine prices would promote the Long Term Interests of End Users (LTIE), and for this reason it codified this methodology in the Fixed Principles. It would not be appropriate to now depart from the Fixed Principles simply in order to deliver a particular price outcome. Rather, in order to deliver a price outcome which promotes the LTIE, the ACCC should apply the Fixed Principles methodology without any pre-judgment of the price outcome.

Telstra does not agree that an outcome where access prices are increased would be "irrational". In circumstances where the supply of declared services involves significant fixed costs and demand for those services is declining, an increase in prices would be highly likely under a building block model approach to price regulation.

A nominal price increase would not be out of step with past regulatory decisions in telecommunications and other sectors. In previous decisions in telecommunications and other sectors, there have been changes in regulated prices in both directions.

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[1] iiNet submission, p 4.

Accounting for the impact of declining demand under the Fixed Principles

A number of industry submissions have focused on the potential impact of declining demand for fixed line services on service prices. This issue was also addressed in the ACCC's Position Paper, in the context of declining demand caused by migration of customers to the NBN.

Telstra considers that there are two key questions which need to be addressed in assessing any proposal to adjust the pricing methodology to account for the potential impact of declining demand:

1. Is there a problem or issue which may arise due to declining demand, which needs to be addressed through adjustments to the pricing methodology?

2. If there is a problem, what adjustments can be made to the pricing methodology under the Fixed Principles?

In relation to the first point, Telstra does note believe there is a problem which necessitates adjustments to the pricing methodology. As noted in Telstra's primary submission, although demand for fixed line services is forecast to decline significantly over the next five years, Telstra's current modelling (premised on the NBN Base Case Scenario) indicates that prices can be held relatively constant in real terms over that period.

Telstra's current modelling indicates that although, a one-off nominal increase in prices in FY2016 would be required in order to allow Telstra an opportunity to recover its costs, in real terms prices would be lower by FY2019 than they are today. This is despite a significant decline in fixed services demand forecast over the same period, taking into account migration to the NBN.

The main reason why it is expected that prices can be held relatively constant, despite rapidly declining demand, is that Telstra has forecast large reductions in its expenditure requirements and declining relative usage of the network by declared services (meaning that under a fully allocated cost framework, the share of costs allocated to declared services will also fall).

Telstra understands that the ACCC and some access seekers may be concerned about what is referred to as the "last customer problem" – that is, as demand for fixed line services approaches zero (near the end of the NBN migration period), remaining customers may face very high per-unit costs. In Telstra's view there is no evidence to suggest that this will be a problem. On the contrary, based on current trends in demand and expenditure requirements, Telstra projects that unit costs will in fact not materially increase in real terms as the end of the NBN migration period approaches.

The main reasons for this are:

- as noted above and in Telstra's main submission, Telstra is forecasting large reductions in expenditure requirements as demand declines;

- any assets which will no longer be used to supply fixed line services and which are to be transferred to the NBN will be treated as 'disposals' in accordance with the Fixed Principles. This means that the remaining value of these assets as at the time of disposal will not need to be recovered through fixed line service prices;

- those assets which will no longer be useful at the end of the NBN migration period but which will not be transferred to NBN Co (e.g. copper cables in areas to be covered by FTTP) are mostly heavily depreciated already, and will continue to depreciate over the next five years. This means that there will be very little remaining value in these asset classes in the RAB by the end of the migration period; and

- for those assets which will continue to be useful after NBN migration is completed (e.g. ducts and pipes), their remaining value in the RAB will be progressively allocated away from declared services, as these services' relative usage of the network declines.

Given the above, there is no basis, either in terms of the fixed principles or due to any exigency associated with the NBN migration, to depart from the BBM framework to specifically account for the impact of declining demand. A straight-forward application of the building block methodology which is codified in the Fixed Principles will not cause any 'problem' in the presence of declining demand caused by NBN migration. Under the Base Case NBN rollout scenario, prices are expected to fall in real terms over the next period and current projections indicate that no "last customer problem" is likely to materialise.

Even if a perceived problem did exist in terms of the last remaining customers on the network potentially facing very high per-unit costs, the Fixed Principles are clear as to how this should be addressed. Under the Fixed Principles, these types of "inter-generational equity" issues can be addressed through adjustments to the depreciation schedule. For example, if there is a concern that end-users in ten years' time may face much higher prices than end-users in the current period, this may be addressed through accelerated depreciation on some assets. Such an approach would address the inter-generational equity issue, while complying with the Fixed Principles and ensuring that the remaining cost of the fixed line network is shared proportionately among all end-users.

What is not permitted under the Fixed Principles is any adjustment to the RAB or the allocation factors which has the effect of denying Telstra an opportunity to recover the remaining value of its investments in the fixed line network, as has been proposed in some industry submissions. For example iiNet argues that the RAB should be adjusted "*to the extent necessary to offset the decline in demand caused by the NBN*".[2]

Such adjustments cannot be made in the current circumstances, for three reasons:

- **First, such adjustments are simply not consistent with the proper application of the Fixed Principles**. The Fixed Principles specify a 'locked in' initial RAB value, with adjustments between periods to account for new capital expenditure, depreciation and asset disposals only. There is no scope under the Fixed Principles to remove the value of decommissioned assets, or "*an appropriate share of assets utilised to a lesser extent*" (as proposed in the ACCC Position Paper), or to otherwise adjust the RAB to offset the impact of declining demand, unless (and only to the extent to which) assets are disposed of or depreciated;

- **Second, this would not be in the LTIE because it would strand efficiently incurred investment**. If such adjustments were to be made, this would imply that Telstra would be deprived of an opportunity to recover the cost of its investments in the fixed line network. This includes investments made following the establishment of the RAB, which now account for more than 43% of the regulatory asset base value. Such an approach would not promote efficient investment in, and use of, infrastructure, and therefore would not be in the LTIE.

- **Third, any failure to fully allocate capital costs across all network services constitutes an explicit and discriminatory cross-subsidy from Telstra's retail customers to wholesale customers.** Any approach to cost allocation that "assumes away" costs under a partial allocation framework, implies that the cost of those assets is to be borne entirely by Telstra retail end-users. This involves accepting two errant assumptions – that wholesale customers need not pay prices that reflect their proportional share of network costs and that it is appropriate for Telstra to seek to recover the resulting shortfall through retail prices. As well as being inconsistent with the Fixed Principles and conventional regulatory practice, this is also not in the LTIE as it clearly distorts the efficient operation of competition in the market.

These issues are addressed in detail in the body of this submission.

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[2] iiNet submission, p 19.

Relevance of commercial arrangements between Telstra and NBN Co

Telstra understands that one justification being put forward by access seekers for additional adjustments to the RAB or the allocation factors (beyond those permitted by the Fixed Principles), is that Telstra is being compensated for the effect of such adjustments through payments from NBN Co.

On this point, Telstra strongly agrees with the views expressed in the ACCC Position Paper, that payments made by NBN Co to Telstra should not be taken into account in setting prices for declared services. Telstra also agrees with the ACCC that the reasons why this approach should be taken are straightforward.

Consistent with this, payments from NBN Co should not be taken into account in considering whether to adjust the RAB to account for declining demand associated with migration of customers to the NBN. Even if such adjustments were permitted under the Fixed Principles (which they are not), they cannot be justified on the basis that Telstra is receiving payments from NBN Co under commercial arrangements.

In any event, the ACCC cannot form the view that NBN payments compensate Telstra for any adjustments to the RAB or the allocation factors (outside of those permitted by the Fixed Principles), without evidence. As has previously been explained, Telstra's acceptance of the commercial deal with NBN Co was not on the basis that it would adequately "compensate" for the decline in demand for line services associated with migration of customers to the NBN and/or potential stranding of fixed line network assets – as noted in the independent expert report presented to shareholders, this was not a relevant question given that the decision to roll out the NBN had already been made.[3] Rather, the reason Telstra's directors and shareholders accepted the proposed deal was that on balance, this was preferable to the consequences of not accepting the deal, including being forced to compete with NBN Co. Similarly, from NBN Co's perspective, it was not required to ensure that Telstra was adequately compensated for any decline in demand or stranding of assets; rather, NBN Co's interest was in ensuring Telstra had a sufficient incentive to co-operate in the NBN rollout.

In considering whether to enter into the deal with NBN Co, Telstra did not assess whether the deal would compensate it for stranding of depreciation costs associated with its fixed-line assets. This was not a 'cost' or 'loss' that Telstra expected would materialise under an NBN migration scenario, and therefore it did not seek to be compensated for this through the deal.

It should be noted that Telstra's negotiation of its commercial arrangements with NBN Co happened around the same time as the ACCC was moving to a building block form of regulation and locking this in through the Fixed Principles. Telstra (and other stakeholders) had welcomed this change in the form of regulation, on the basis that it would provide greater certainty and put an end to perennial debates around revaluation of the asset base. While Telstra disagreed with the initial RAB valuation, it was prepared move forward on the basis of a regulatory framework which provided greater certainty around its ability to recover its past investments, as valued by the ACCC.

By the time Telstra accepted the deal with NBN Co, the ACCC had already made its commitment to the use of a building block method for determining prices for declared services, and had codified this method in the Fixed Principles. Therefore Telstra would have had a reasonable expectation at that time that it would be able to recover the remaining value of its fixed line network assets (as valued by the ACCC in the 2011 FAD) through prices for fixed line services. Based on the commitments made by the ACCC in the 2011 FAD process, it would not be expected that Telstra would have required compensation through commercial arrangements with NBN Co for any stranding of assets.

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[3] Grant Samuel and Associates, Financial Services Guide and Independent Expert's Report in relation to the proposed transaction with NBN Co Limited and the Commonwealth, 31 August 2011, p 31.

1. The Fixed Principles must be the touchstone for setting prices

Telstra has explained in its primary submission that the Fixed Principles must be the touchstone for setting prices.

The Fixed Principles lock in a conventional and well understood methodology for determining prices. Therefore the focus of this inquiry should be on properly applying this methodology, not on engineering a particular price outcome.

1.1 The Fixed Principles prescribe a method, not a price outcome

Telstra is concerned that too much of the focus of access seeker submissions has been on engineering a particular price outcome, rather than on ensuring the method for determining prices is sound. For example the iiNet submission argues that "the ACCC should not lose sight of outcomes".[4] iiNet states that what the ACCC must ultimately consider is which of three possible price outcomes – an increase, decrease or no change in service prices – is most appropriate in the current circumstances. The iiNet submission also seeks to rule out certain price outcomes, by arguing that an increase in service prices would be "irrational".

Telstra considers that, while outcomes are important, the pricing approach adopted by the ACCC should not be dictated by a desire to deliver a certain price outcome. Certainly, the ACCC should not be departing from the methodology prescribed by the Fixed Principles, in order to deliver a particular price outcome.

As explained in Telstra's primary submission, the Fixed Principles lock in the *methodology* to be applied in determining prices for the declared fixed line services and establish principles to be applied in determining inputs into this methodology.[5] Therefore in Telstra's view, the key task of the ACCC in this FAD inquiry is to apply the methodology prescribed by the Fixed Principles, and determine all inputs into this methodology in accordance with those principles. The ACCC should not be forming a view as to the appropriate price outcome, and then designing its methodology so as to achieve that outcome.

The matters addressed by the Fixed Principles were the subject of a determination by the ACCC in 2011. The ACCC determined that it was in the LTIE to adopt the price-setting methodology that is reflected in the Fixed Principles – i.e. a building block pricing method. Moreover, the ACCC determined that is was in the LTIE to 'lock in' use of this methodology for an initial period of ten years, until June 2021.

In effect, matters relating to pricing methodology have already been determined and locked in through the Fixed Principles. The application of the Fixed Principles has, therefore, already been determined to be in the LTIE. It is not open to the ACCC to seek to revisit matters of pricing methodology in making replacement FADs, to the extent that these methodological matters are already addressed by the Fixed Principles.

To the extent that the ACCC has discretion under the Fixed Principles to determine particular inputs – for example, in relation to prudency of expenditure, the rate of return, or price relativities between services – its exercise of this discretion should be guided by the statutory criteria and object of Part XIC of the Act. However in no circumstances can the ACCC depart from the Fixed Principles methodology.

[4] iiNet submission, p 5.
[5] Primary submission, pp 22-23.

1.2 Adhering to the Fixed Principles will lead to outcomes which promote the LTIE

Adherence to the pricing method prescribed by the Fixed Principles will lead to price outcomes which promote the LTIE. A method which ensures that Telstra has a reasonable opportunity to recover its costs and which provides for fair sharing of these costs among all network users will:

- promote efficient and sustainable competition, because access prices will be both compatible with competition and with the continued efficient provision of the access service; and
- encourage efficient investment, as the access provider will have an opportunity to recover efficiently incurred investment costs.

This relationship between cost-reflective access pricing and the promotion of competition is explained in the accompanying expert report of Mr Jeff Balchin (Appendix 2). Mr Balchin explains:[6]

> *As noted above, the effect of Telstra's proposal is that access prices should be set in line with the cost of providing the access service, so that the incentive and capacity for continued provision of the access service is thereby provided. It would be extraordinary if access prices determined in such a manner were incompatible with the creation of competition in related markets. Rather, the better view is that setting cost reflective access prices will be compatible with efficient or sustainable competition, in that such access prices will be both compatible with competition and with the continued efficient provision of the access service. Such an outcome would not be achieved if the building block approach was instead back-engineered to create a predetermined (non-cost reflective) price.*

1.3 The suggestion by iiNet that the ACCC pre-determine a price outcome would create a high risk of error

The outcome of this inquiry cannot be pre-judged by any party. The process for determining prices is clearly prescribed by the Fixed Principles, and the outcome of this process may either be an increase or a decrease in service prices, depending on the relative changes in cost inputs and forecast demand for network services between regulatory periods.

In Telstra's view, the manner in which iiNet have sought to frame the ACCC's task as being to consider three possible price outcomes – an increase, decrease or no change in service prices – is inappropriate. If the outcome of the price determination process were to be pre-judged, this would introduce a high risk of error. In particular, such an approach may lead to a risk that the determination of individual inputs or methodologies may be biased towards achieving the pre-judged outcome. The end result may be that the ACCC's determination is inconsistent with the Fixed Principles and the statutory criteria.

1.4 An increase in fixed line prices would not be "irrational"

Some access seeker submissions have argued that any increase in prices for fixed line services would be an "irrational outcome". The implication of this is that prices can only go down. This reflects an explicit pre-judgment as to the outcome of the ACCC's inquiry.

Telstra understands that there are essentially two reasons put in support of this submission:

- firstly, in a hypothetical scenario where there is competition for the supply of fixed-line services, it would not be rational for Telstra to increase prices without any investment to increase service quality. In essence, the argument seems to be that such an outcome

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[6] Incenta, *Cost allocation and declining demand for fixed line telecommunications services: comments on submissions and the ACCC proposal paper*, December 2014, p 11.

would not be expected in a competitive market, and therefore should not be allowed in regulated setting either;

- secondly, an increase in prices designed to allow Telstra an opportunity to recover its sunk investment in the fixed line network assets would result in a "windfall" for Telstra. It is asserted that a windfall gain would accrue because "Telstra is being compensated by NBN Co for the effects of falling demand".[7]

In relation to the first point, Telstra does not agree that an increase in prices could not occur in a competitive market. A key feature of competitive markets is that businesses need to be able to recover their costs of supply over the long run. This implies that if unit costs were to rise, market prices would need to increase.

Mr Balchin notes, in the accompanying expert report (Appendix 2):[8]

> *In competitive markets, investors must expect to recover their costs (including a commercial return) otherwise investment would not occur. When costs are expected to be recovered over an extended period, then an investor would either be expected to seek compensation for taking on demand risk (i.e., by setting a higher price), or shield itself from the risk of declining demand (i.e., by requiring a long term contract with fixed commitments).*
>
> *Thus, full cost recovery in the face of declining demand is the same outcome that arises in a competitive market where investment is made under efficient long term contracts, and so is consistent with the outcome of a competitive market.*

The hypothetical of a perfectly competitive market is not relevant as there simply is no perfectly competitive market for the supply of fixed line access services, and it is for this reason that the supply of these services is regulated.

As has been observed by the ACCC, the supply of fixed line network access is more akin to a natural monopoly service, rather than a competitive market service. Therefore it would be an error to use a hypothetical competitive market model to project price outcomes for the fixed-line network.

A key feature of natural monopolies (and a key point of distinction from the competitive market model) is pervasive economies of scale – that is, large fixed costs and declining average costs over most (or all) market demand. The implication of this is that where demand for services provided by a natural monopoly declines, average costs will rise. Where prices are set to recover average costs, prices will need to rise where there is a decline in demand. This is shown in Figure 1 below – as demand shifts downwards from D_1 to D_2, the price based on average cost needs to increase from P_1 to P_2.[9]

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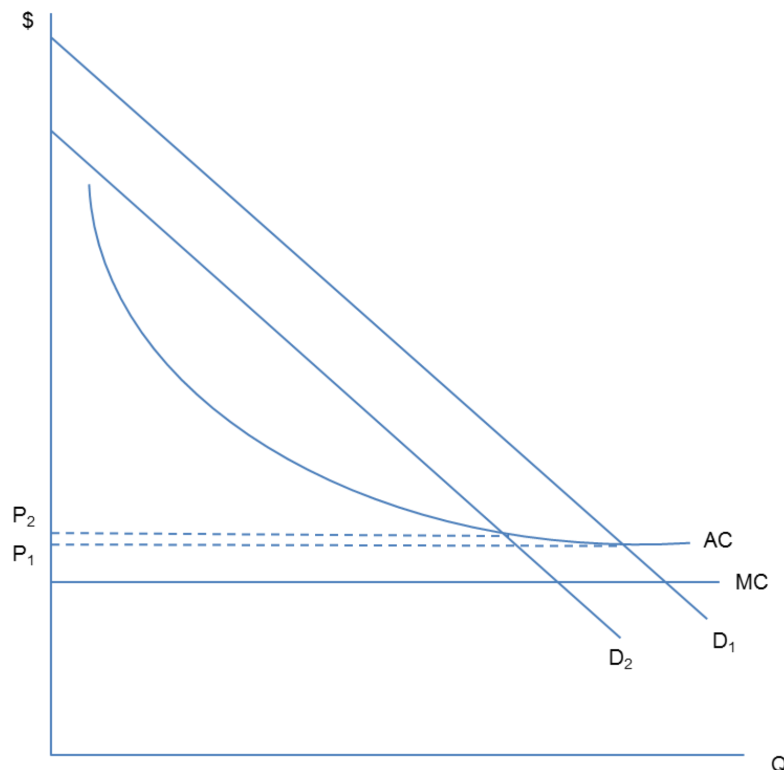
[7] iiNet submission, p 6.

[8] Incenta, *Cost allocation and declining demand for fixed line telecommunications services: comments on submissions and the ACCC proposal paper*, December 2014, p 6.

[9] A widely acknowledged problem with price-setting for natural monopolies is that, due to pervasive economies of scale, marginal cost will be below average cost. This means that setting prices based on marginal cost alone will not allow for recovery of costs. In order to allow for cost recovery, prices must be set equal to average cost and/or the monopolist will need to be subsidised for the difference between marginal and average cost (the other alternative which is not typically used is to allow the monopolist to price discriminate). Whether pricing is based on average cost or based on marginal cost with a subsidy to the monopolist, the impact of declining demand will be the same. This is because the shape of the average cost curve will not change if there is a subsidy to allow for marginal cost pricing – rather, the average cost curve will simply shift down, towards the marginal cost curve.

Figure 1: Effect of declining demand in a natural monopoly setting



Further, due to the way in which prices are calculated by the ACCC, using a conventional building block method, regulated prices will not necessarily move as they would in a competitive market. As the ACCC is aware, building block cost models rely on many assumptions about how costs are calculated and recovered over time through prices, which may or may not reflect the way prices are determined in a competitive market. These include:

- **Valuation of assets**. In many utility pricing models (including the model relied on by the ACCC), an initial asset valuation is 'locked in' and then rolled forward based on new capital expenditure, asset disposals and depreciation. In the ACCC pricing model, the initial asset valuation was based on historic cost, with explicit adjustments designed to deliver a particular regulated price outcome for the ULLS. It is very unlikely that this is how assets would be valued when considering prices needed to recover costs in a competitive market.

- **Timing of cost of capital reset**. In utility pricing models, it is assumed that the cost of capital is effectively reset each time prices are reviewed. One implication of this is that regulated prices may rise or fall as a result of changes in the prevailing cost of capital between resets. However this is unlikely to reflect the timing of changes to the cost of capital for firms in competitive markets – for example, competitive firms may refinance debt at more frequent intervals, in order to hedge against refinancing risk.

- **Timing of capital cost recovery**. Utility pricing models employ certain assumptions about the timing of capital cost recovery, which may or may not match how competitive firms seek to recover capital costs over time. A common assumption of utility pricing models is that depreciation is recovered evenly over the economic life of the relevant assets.

In light of these differences, Telstra considers that no judgement can reasonably be made as to the likely direction or magnitude of price changes that should result from the application of a utility regulation model, based on a 'perfectly competitive market' thought experiment.

1.5 A nominal price increase would not be out of step with past decisions in telecommunications and other sectors

As explained in Telstra's primary submission, we have undertaken indicative modelling showing that a nominal increase to prices is required to ensure that Telstra is provided with a reasonable opportunity to recover its efficient costs over the forthcoming regulatory periodThis increase would apply at the commencement of the regulatory period (FY16) and will be less than the increase CPI over the regulatory period. A nominal increase:

- would not be out of step with wholesale price changes introduced by the ACCC in previous regulatory periods;
- is conservative when compared to approved price changes in other regulatory environments impacted by declining demand; and
- is unlikely to have any material impact on the wholesale or retail market by ensuring that access seekers maintain high margins in the supply of fixed services.

Each of these points is discussed briefly below.

1.5.1 Price rises for regulated wholesale services are not unprecedented

The below table summarises the price changes in regulated prices since January 2006.

Table 1: Regulated prices for fixed services over time (January 2006- November 2014)[i]

Service	Price – January 2006	Price (as at November 2014)	Delta (%)
Band 1 ULLS	$5.60	$16.21	189%
Band 2 ULLS	$12.30	$16.21	32%
Band 3 ULLS	$25	$16.21	-35%
Band 4 ULLS	N/A	$48.19	N/A
WLR (Res)	$23.12	$22.84	-1%
LCS	$.1792	$.0890	-49%
LSS	$2.50	$1.80	-39%
OTA	$.01	$0.95	-5%
WDSL (Port)	N/A	$25.40 (Zone 1) / $30.80 (Zone 2 / 3)	N/A
WDSL (AGVC)	N/A	$45.50	N/A

Since January 2006, the ACCC has increased regulated access prices on fifteen separate occasions.

The most notable price increases are discussed below:

- Over thirteen months, between June 2007 and July 2008, the price of Band 2 ULLS rose by 16.3%.
- In January 2011, the price of Band 1 ULLS rose by almost $10 per service, harmonising this price with that of ULLS services in Bands 2 and 3 respectively. This equates to a price increase of 142%.
- In January 2008, the price of WLR rose by 10.6%.

1.5.2 Compared to other regulated industries, the proposed price increase would be modest

Over time, the cost of providing regulated services changes, and regulated rates sometimes increase in response to changing industry circumstance.

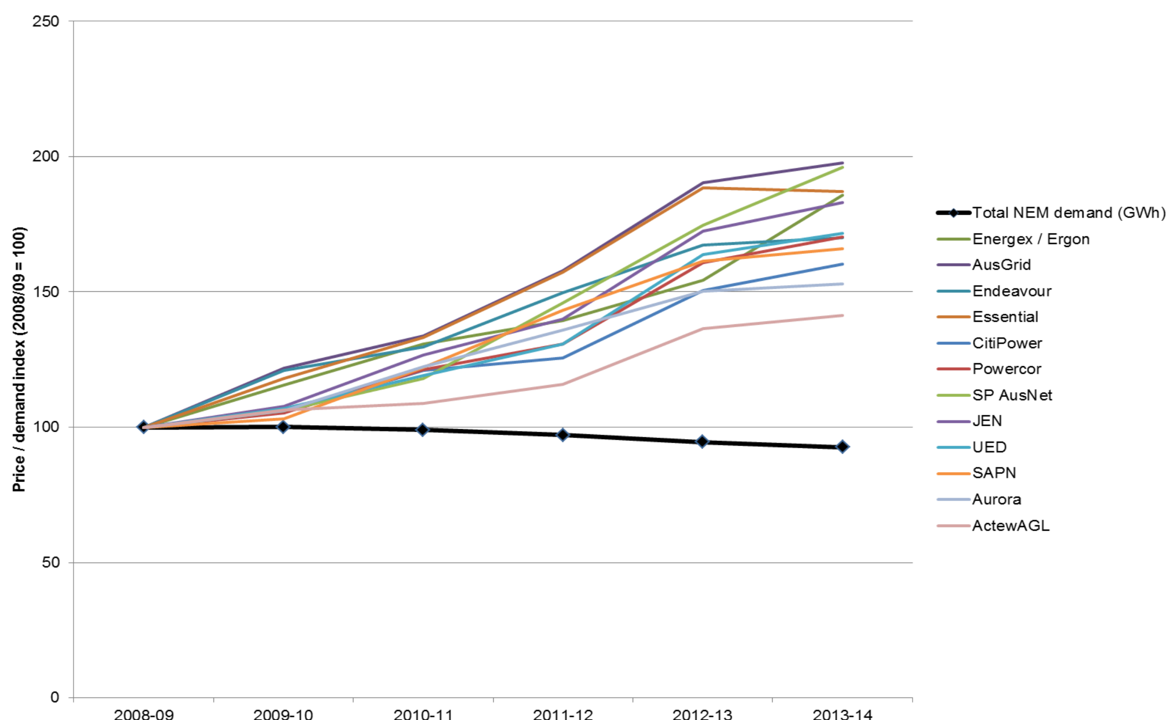
Other regulated industries such as electricity distribution and postal services also use a BBM methodology to determine prices for regulated services. These industries also face similar challenges to those being faced by Telstra in the forthcoming regulatory period, namely, declining demand, aging infrastructure and high fixed costs.

Recent experience in these other regulated industries does not support an assumption that prices can only fall where demand for services is declining, as has been suggested in some access seeker submissions. For example:

- in the postal sector, basic postage rates (**BPR**) have recently increased by more than 10%, from 60 cents to 70 cents. In its decision to not object to the proposed increase, the ACCC observed that part of the reason why a BPR increase was required was that letter volumes had been declining;[10]

- in the electricity sector, there have been very significant price increases over the past five years, at the same time as demand for electricity has been declining across the National Electricity Market (**NEM**). Figure 2 below shows the change in total NEM demand over the past five years, and changes in retail electricity prices by distribution area. In some areas, retail electricity prices have nearly doubled over this period.

Figure 2: Electricity demand and prices in the NEM (by distribution area)[11]



[10] ACCC, *Australia Post price notification for its 'ordinary' letter service*, February 2014.
[11] Source: AER State of the Energy Market 2013, Table 5.3 (price data); AEMO Electricity Statement of Opportunities, August 2014, Figure 2 (demand data).

In this context, and given that demand for fixed-line services is forecast to decline by more than 50% over the next five years, it may be expected that there would need to be a larger increase in service prices. It is only because Telstra is forecasting very significant cost savings that the required price increase can be kept to below the forecast rate of inflation.

1.5.3 Based on historic evidence, the proposed wholesale price increases are unlikely to have a material impact on the retail market

Some access seeker submissions have expressed concern that if prices for wholesale access services were to rise, this may affect take-up of these services and/or may harm competition in downstream markets.

Recent experience in telecommunications markets does not support this theory. For example:

- Take up of ULLS in Band 2 has been increasing steadily since the service was first introduced. This is despite there being price increases for this service in recent years, both in absolute terms and relative to the price other services such as WLR. For example in July 2008, the ACCC increased the price of ULLS in Band 2 from $14.30 / month to $16 / month. In the years following this price change, the rate of ULLS growth actually increased by approximately 6-7% per quarter, consistent with the long term average. [12]

- In January 2011, the price of Band 1 ULLS rose by almost $10 per service, harmonising this price with that of ULLS services in Bands 2 and 3 respectively. This price increase, in excess of 140% represents the most substantial price change in the last ten years. Despite this substantial price increase, wholesale demand for Band 1 ULLS following the price increase has not altered materially. Average demand growth in the periods following this change have remained largely consistent when compared with average growth rates in periods prior to this price change , at 3,9% vs. 4.0% respectively. [13] This is an interesting observation given the magnitude of the change which should in theory have shifted access seeker demand to alternative substitute services. In this instance, such an outcome has not been observed.

- In January 2011, the ACCC reduced the price of LSS from $2.50 to $1.80 (a decline of 38%). Despite this significant reduction in price, LSS SIOs continued to decline and in fact, the rate of decline accelerated after the price decrease with SIOs reducing on average by -1% each quarter.[14] In the two years prior to this price change, LSS growth was on average 5% per quarter. [15]

This recent experience suggests that a nominal price increase for regulated services will not materially affect uptake of these services, particularly if (as proposed by Telstra) existing price relativities are maintained.

[12] Computed on a quarterly basis from September 2007-June 2014

[13] In assessing this, Telstra compared the average quarterly growth rates between the periods July 2008 – December 2010 and Jan 2011 – June 2013. This equates to ten quarters of data either side of the price change.

[14] Telstra CAN RKR. Based on the average quarterly growth decline for period January 2011 – June 2014.

[15] Telstra CAN RKR. Based on the average quarterly growth decline for period Jan 2009- December 2010.

2. Accounting for the impact of declining demand

A number of industry submissions have focused on the potential impact of declining demand for fixed line services on service prices. This issue was also addressed in the ACCC's Position Paper, in the context of declining demand caused by migration of customers to the NBN.

Telstra considers there are two key questions which need to be addressed in assessing any proposal to adjust the pricing methodology to account for the potential impact of declining demand:

1. Is there a problem or issue which may arise due to declining demand, which needs to be addressed through adjustments to the pricing methodology?

2. If there is a problem, what adjustments can be made to the pricing methodology under the Fixed Principles?

Each of these questions is addressed below.

2.1 Is declining demand an issue that requires adjustments to the conventional price-setting method?

It is not clear to Telstra that there is a problem which necessitates adjustments to the pricing methodology. At this stage, no party has provided evidence of any problem. Rather, submissions at this stage have largely focused on hypothetical or theoretical issues.

The most commonly raised concern in relation to declining demand is that unit costs (and therefore prices) may need to rise significantly as demand for services declines, potentially leading to further declines in demand if customers are price-sensitive. This theory assumes that the cost base remains relatively constant as demand declines.

The evidence provided by Telstra in its primary submission demonstrates that this theoretical scenario is unlikely to materialise in this particular case. As noted in Telstra's primary submission, although demand for fixed line services is forecast to decline significantly over the next five years, Telstra's current modelling (premised on the NBN Base Case Scenario) indicates that prices can be held relatively constant in real terms over that period. This is because, despite rapidly declining demand, Telstra has forecast large reductions in its expenditure requirements and declining relative usage of the network by declared services (meaning that under a fully allocated cost framework, the share of costs allocated to declared services will also fall).

Telstra understands that there may be a concern in relation to what is referred to as the "last customer problem" – that is, as demand for fixed line services approaches zero (near the end of the NBN migration period), remaining customers may face very high per-unit costs. However in Telstra's view there is no evidence to suggest that this will be a problem. On the contrary, based on current trends in demand and expenditure requirements, Telstra projects that units costs will in fact not materially increase in real terms as the end of the NBN migration period approaches.

There are four main reasons for this:

- first, as noted above and in Telstra's main submission, Telstra is forecasting large reductions in expenditure requirements as demand declines;

- secondly, any assets which will no longer be used to supply fixed line services and which are to be transferred to be NBN will be treated as 'disposals' in accordance with the Fixed Principles. This means that the remaining value of these assets as at the time of disposal will not need to be recovered through fixed line service prices;

- thirdly, those assets which will no longer be useful at the end of the NBN migration period but which will not be transferred to NBN Co (e.g. copper cables in areas to be covered by FTTP) are mostly heavily deprecated already, and will continue to depreciate over the next

five years. This means that there will be very little remaining value in these asset classes in the RAB by the end of the migration period;

- finally, for those assets which will continue to be useful after NBN migration is completed (e.g. ducts and pipes), their remaining value in the RAB will be progressively allocated away from declared services, as these services' relative usage of the network declines.

Telstra considers that a straight-forward application of the building block methodology which is codified in the Fixed Principles will not cause any 'problem' in the presence of declining demand caused by NBN migration. Certainly, there does not appear to be any 'problem' in terms of price outcomes for the next period, and current projections indicate that the "last customer problem" is unlikely to materialise in this context. Therefore, there does not appear to be any need to adjust the methodology to specifically account for the impact of declining demand.

2.2 If there is an issue caused by declining demand, how can it be addressed under the Fixed Principles?

If there was any perceived problem in terms of the last remaining customers on the network potentially facing very high per-unit costs, the Fixed Principles are clear as to how this can be addressed.

Under the Fixed Principles, these types of "inter-generational equity" issues can be addressed through adjustments to the depreciation schedule. For example, if there is a concern that end-users in ten years' time may face much higher prices than end-users in the current period, this may be addressed through accelerated depreciation on some assets. Such an approach would address the inter-generational equity issue, while complying with the Fixed Principles and ensuring that the remaining cost of the fixed line network is shared proportionately among all end-users.

Of course, any adjustments to the depreciation schedule should only affect the *timing* of capital cost recovery, not the total amount to be recovered. In other words, any adjustment should be NPV-neutral.

Adjustments to the depreciation schedule are expressly contemplated in other regulatory regimes that utilise building block methodologies. For example, under the National Gas Rules (**NGR**), adjustments can be made to the depreciation schedule between access arrangement periods, provided that the depreciation schedule for any period meets certain criteria.[16] The NGR also expressly contemplate that it may be appropriate to 'front-load' or 'back-load' depreciation in some circumstances.[17]

2.3 Adjustments to the price-setting method that are not permitted under the Fixed Principles

What is not permitted under the Fixed Principles is any adjustment to the RAB or the allocation factors which has the effect of denying Telstra an opportunity to recover the remaining value of its investments in the fixed line network, as has been proposed in some industry submissions. For

[16] The criteria are set out in rule 89 of the NGR and state that the depreciation schedule should be designed: (a) so that reference tariffs will vary, over time, in a way that promotes efficient growth in the market for reference services; (b) so that each asset or group of assets is depreciated over the economic life of that asset or group of assets; (c) so as to allow, as far as reasonably practicable, for adjustment reflecting changes in the expected economic life of a particular asset, or a particular group of assets; (d) so that (subject to the rules about capital redundancy), an asset is depreciated only once (ie that the amount by which the asset is depreciated over its economic life does not exceed the value of the asset at the time of its inclusion in the capital base (adjusted, if the accounting method approved by the AER permits, for inflation)); and (e) so as to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs.

[17] For example, rule 89(2) of the NGR states that compliance with the depreciation criteria may involve deferral of a substantial proportion of the depreciation, particularly where: (a) the present market for pipeline services is relatively immature; and (b) the reference tariffs have been calculated on the assumption of significant market growth; and (c) the pipeline has been designed and constructed so as to accommodate future growth in demand.

example iiNet argues that the RAB should be adjusted "*to the extent necessary to offset the decline in demand caused by the NBN*".[18]

Telstra submits that such adjustments cannot be made in the current circumstances, without a corresponding depreciation expense, for two reasons:

- Firstly, such adjustments are not allowed for under the Fixed Principles. The Fixed Principles specify a 'locked in' initial RAB value, with adjustments between periods to account for new capital expenditure, depreciation and asset disposals only. There is no scope under the Fixed Principles to remove the value of decommissioned assets, or "*an appropriate share of assets utilised to a lesser extent*" (as proposed in the ACCC Position Paper), or to otherwise adjust the RAB to offset the impact of declining demand, unless (and only to the extent to which) assets are disposed of or depreciated;

- secondly, even if such adjustments were permitted under the Fixed Principles, it would not be in the LTIE to make these adjustments to the RAB. Removing assets from the RAB without allowing Telstra to recover their remaining (undepreciated) value, or alternatively allocating away their cost under a partial allocation framework, implies that the cost of those assets is borne entirely by Telstra retail end-users.

This is explained in detail in the accompanying expert report of Mr Jeff Balchin (Appendix 2). Mr Balchin states:[19]

> *Removing some or all of the asset value associated with fixed line assets without compensation merely because demand has declined, as has been proposed by the ACCC, would mean that Telstra would not be afforded the opportunity to recover its costs. The ACCC's proposed approach is inconsistent with the fixed principles requirements relating to a prescribed approach to the RAB opening value and roll forward, and the requirement to provide an expectation for full cost recovery in accordance with the proper application of the building block approach.*

Telstra is not aware of any submissions or evidentiary material which has sought to reconcile such proposals with the clear requirements of the Fixed Principles.

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[18] iiNet submission, p 19.

[19] Incenta, *Cost allocation and declining demand for fixed line telecommunications services: comments on submissions and the ACCC proposal paper*, December 2014, p 6.

Appendix 1: Response to specific points raised in industry submissions

Issue raised	Telstra response
An increase in prices for Declared Services would be an irrational outcome	An increase in prices for Declared Services would not be an "irrational outcome", as claimed in the iiNet submission.[20] As discussed in the body of this submission, the outcome of this inquiry cannot be pre-judged by any party. The focus of the ACCC's inquiry should be on ensuring that it properly gives effect to the building block methodology prescribed by the Fixed Principles, and determines all inputs into this methodology in accordance with those principles, without pre-judgement as to the appropriate outcome. In any event, Telstra does not agree that an outcome where access prices are increased would be "irrational". In circumstances where the supply of Declared Services involves significant fixed costs and demand for services is declining, an increase in prices would be highly likely under a building block model approach to price regulation. As discussed in the body of this submission, experience in other regulated industries such as post and energy suggests that price rises should not be unexpected in a declining demand environment. As discussed below and in Telstra's primary submission, it will not necessarily promote the LTIE for access prices to be lowered, if this means that the access provider is unable to recover its efficiently incurred costs.

[20] iiNet submission, p 5.

Issue raised	Telstra response
Competition is promoted through lower prices approaching marginal cost	Competition will not be promoted in this context simply by driving prices down to marginal cost, as claimed by Optus.[21] The simple reason for this is that providing fixed-line services involves large fixed costs. This means that if prices were to reflect marginal cost only, a substantial share of the cost of service provision will not be recovered. Such an outcome would not be in the LTIE, would be inconsistent with Telstra's legitimate business interests and would violate the Fixed Principles. As has been observed by the Full Federal Court, promoting competition is not simply about lowering access prices. Competition cannot be promoted, and thus the LTIE may not be attained, if infrastructure investment is not economically feasible for an efficient service provider to make or support.[22] Similarly, the Australian Competition Tribunal has observed that while very low access prices may be in the short-term interests of end-users, this may not be in the long-term interests if it deters efficient investment and sustainable service delivery over the longer term.[23] It is well established that promoting competition requires the creation of appropriate conditions for competition to occur, not the protection of individual competitors.[24] In Telstra's view, this means allowing the access provider a reasonable opportunity to recover the cost of its investment in the infrastructure used to supply services, while ensuring that access seekers pay no more than is necessary to recover that cost.

[21] Optus submission, p 5.
[22] *Telstra Corporation Limited v ACCC* [2008] FCA 1758.
[23] *Re Seven Network Ltd and Another (No 2)* [2004] ACompT 11.
[24] *Telstra Corporation Limited v Australian Competition Tribunal* [2009] FCAFC 23, at 224-225 (referring to the Tribunal decision in *Re Review of Declaration of Freight Handling Services at Sydney International Airport* (2000) ATPR 41-754 at 40,775).

Issue raised	Telstra response
The Fixed Principles and good regulatory practice must be abandoned if they lead to higher prices	iiNet argues that because Telstra's proposed cost allocation framework leads to higher access prices, it cannot be accepted. iiNet states that "*to accept the CAF on the basis that it is somehow methodologically purer than the ACCC's current approach to cost allocation is simply a case of the tail wagging the dog.*"[25] The implication of this submission appears to be that the ACCC should not do anything which would have the effect of raising prices, even if this means abandoning the Fixed Principles, which among other things require that costs are allocated to services on the basis of their proportional usage of the network. Clearly, the Fixed Principles require the use of a fully allocated cost framework, such as the CAF. Not using the CAF (or similar fully-allocated cost framework) and departing from the Fixed Principles would clearly not be in the LTIE. The ACCC has determined (in the 2011 FADs) that applying a building block methodology to determine prices would promote the LTIE, and for this reason it codified this methodology in the Fixed Principles. It would not be appropriate to now depart from the Fixed Principles simply in order to deliver a particular price outcome. As explained above, it will not necessarily promote the LTIE for access prices to be lowered, if this means that the access provider is unable to recover its efficiently incurred costs. This has been recognised by the Federal Court and the Tribunal in several cases, referred to above. As noted in the body of this submission, rising access prices have been a feature of several other regulated sectors in recent years, particularly those where demand for regulated services has been declining. There have also been some increases in access prices in the telecommunications sector, without any apparent harm to consumers (refer to section 1.4 above).
The Fixed Principles do not require a fully allocated cost framework	The iiNet submission argues that the Fixed Principles do not require the ACCC to set prices on the basis of the relative usage of all services that use the network. Rather, iiNet argues that the Fixed Principles only require that the allocation of costs of operating the PSTN should reflect relative usage of the network by *declared* services.[26] If that were the case, it would render the cost allocation principles largely meaningless. This interpretation implies that any arbitrary allocation may be made between declared services and other services using the fixed line network. At one extreme, it could imply that there need not be any allocation of costs to other services and that declared services should bear 100% of the costs of operating the PSTN (with this cost pool to be allocated among the declared services on the basis of relative usage).

[25] iiNet submission, p 8.
[26] iiNet submission, pp 13-15.

Issue raised	Telstra response
If the allocation framework is to be revisited, then the initial RAB value must be reopened	Clearly the initial RAB value cannot be revisited by the ACCC. The value of the initial RAB is locked in under the Fixed Principles. Even if this were permitted by the Fixed Principles, it would not be appropriate to do so. The initial RAB value was the product of a lengthy consultation process in which the ACCC considered a range of methodologies and took into account various considerations. Further, the Fixed Principles clearly require that costs are allocated to services on a fully-allocated cost basis. There is no need to revisit the Fixed Principles in order to adopt a fully-allocated cost framework.
The Fixed Principles allow the RAB to be adjusted for reduced utilisation of assets	The RAB cannot simply be adjusted to offset the decline in demand caused by the NBN, as argued by iiNet.[27] Similarly, the RAB cannot be adjusted to remove the value of assets decommissioned or "*utilised to a lesser extent*" due to migration of customers to the NBN, as proposed by the ACCC in its Position Paper. Such adjustments are simply not allowed for by the Fixed Principles. Under the Fixed Principles, the RAB is rolled-forward (and adjusted in value) through either additions, depreciation or disposals. Other, ad hoc, adjustments (such as to account for reduced utilization) to the RAB are not permitted. Moreover, as discussed in the body of this submission, adjusting the RAB in this way would imply that the burden of cost recovery for these assets would be borne entirely by Telstra retail customers and/or Telstra shareholders – in effect, Telstra's customers and shareholders would be asked to subsidise access seekers' customers and shareholders.

[27] iiNet submission, p 19.

Issue raised	Telstra response
Telstra is seeking compensation for loss of market share	A number of submissions have argued that Telstra should not be compensated for loss of market share.[28] Telstra is not seeking compensation for loss of market share. Telstra is simply seeking to ensure that it has an opportunity to recover the cost of providing network access, and that this cost recovery burden is shared proportionately among all network users. Under Telstra's proposed fully allocated cost framework, there is no "compensation" to Telstra when a customer moves from a Telstra retail service to a WLR-based competitor service. Under this scenario Telstra recovers the cost of providing network access for that customer through wholesale charges rather than retail charges, but the total amount that is recovered for network access would not change. While the share of network costs allocated to wholesale services would increase as wholesale's relative usage of the network has increased, the price of WLR would not be expected to rise because the number of WLR services (the denominator for pricing) has also increased. All that changes, in terms of the overall "compensation" to Telstra, is that Telstra would lose any retail margin it may have been earning from that customer. Similarly, Telstra is not "compensated" when a customer leaves the fixed line network altogether. Rather, the remaining costs of operating and maintaining the fixed line network must be recovered across a smaller customer base. To the extent that the overall cost of maintaining the network does not decline proportionately with the reduction in network usage, this implies that the per-unit cost may rise across all remaining services, including Telstra retail services and wholesale services.
Telstra sees competition as detrimental to the LTIE and is seeking to maintain a dominant position	Optus says that Telstra sees competition during the transition NBN as being detrimental, and claims that "*Telstra is essentially arguing that the roll [sic] of access pricing is to ensure that the dominant incumbent maintains its current dominant market share during transition to NBN.*"[29] These claims by Optus are incorrect and highly misleading. Telstra has never argued that efficient competition would be detrimental to the LTIE. Where Telstra refers to the potentially detrimental effects of "intra-migration", it is referring to the potential shifting of demand between wholesale services (e.g. migration from ULLS to WLR, or vice versa), in response to changes in price relativities. As explained in Telstra's submission, if existing price relativities are not maintained, there may be very significant changes to these relativities as prices are adjusted, potentially leading to inefficient intra-migration.

[28] iiNet submission, pp 16-18; Optus submission, p 6.
[29] Optus submission, p 5.

Issue raised	Telstra response
Telecommunications regulation is not the same as electricity or gas	It is true that telecommunications regulation is not the same as electricity or gas. However, there are many similarities in the objectives and approach to regulation in these industries. Indeed the building block method for determining prices, which is codified in the FADs, was modelled on those applied in the energy sector. In relation to the two points of distinction raised in the Optus submission:[30] • it is not true that all businesses regulated by the AER are single product, single network monopolies. For example the APA Group, which is the operator of several regulated (or 'covered') gas pipelines and gas distribution systems, also operates a broad portfolio of unregulated assets. Nevertheless, the APA Group's covered pipelines are still regulated by the AER in such a way that allows APA a reasonable opportunity to recover the costs of their investments in those pipelines; • similarly to the national electricity objective (and the national gas objective) the object of Part XIC also requires the ACCC to have regard to the objective of encouraging the economically efficient use of, and the economically efficient investment in infrastructure.[31] It is true that the object of Part XIC also requires the ACCC to have regard to the objective of promoting competition. However, as noted above, it is well established that competition cannot be promoted, and thus the LTIE may not be attained, if infrastructure investment is not economically feasible for an efficient service provider to make or support. Therefore, Telstra does not agree that a fundamentally different approach to application of the building block method is justified in this context.
Telstra faces only the marginal network cost to supply retail services	Optus claims that Telstra only faces the marginal network cost to supply retail services, and therefore holds an advantage over wholesale customers, who would face the fully allocated cost (at least under Telstra's proposed approach to cost allocation).[32] This of course assumes that once an investment is made by Telstra, it faces no cost of capital or depreciation on that asset. This is simply not true. Like any other business, Telstra faces ongoing capital costs associated with its fixed-line network investments, in addition to its short-run marginal costs. It is therefore appropriate that these costs be shared proportionately among all network users, including Telstra retail end-users and wholesale customers' end-users.

[30] Optus submission, pp 7-8.
[31] CCA, s 152AB.
[32] Optus submission, pp 8-9.

Issue raised	Telstra response
The relevant question, for Telstra's legitimate business interests, is whether the Telstra Group is profitable	Several submissions refer to the financial performance of the Telstra Group, either on an EBITDA or EBIT basis. It is suggested that the profitability of the Telstra Group should be taken as evidence that Telstra has been able to fully recover the cost of supplying the fixed line services and/or that Telstra's legitimate business interests are adequately accounted for under the ACCC's partial allocation approach.[33] The performance of the broader Telstra Group cannot be taken as evidence of the appropriateness of regulated price settings, given than regulated service revenue accounts for such a small part of Telstra's overall group revenue. Further, EBITDA metrics provide very little information on whether all costs are being recovered, given that depreciation comprises such a large part of the cost base. It is similarly not relevant that Telstra (like several access seekers) has a large mobile network.[34] The relevant question is whether Telstra has a reasonable opportunity to recover the cost of supplying regulated fixed-line services. Telstra was not allowed an opportunity to recover the cost of supplying the fixed line services over the last regulatory period, due to the ACCC's adoption of the 'partial allocation method'.

[33] Optus submission, pp 5-6; iiNet submission, p 13.
[34] iiNet submission, p 20.

Issue raised	Telstra response
Telstra is being compensated for the effects of declining demand through increased mobile volumes or payments from NBN Co	Implicit in some submissions is a suggestion that Telstra need not be allowed an opportunity to recover the remaining value of its sunk investment in the fixed-line network, because it is being compensated by other means for the expected decline in usage of this network – specifically, Telstra is seen to be compensated through a shift in customers from the fixed-line network to its mobile network, and through payments from NBN Co. Some parties have argued that for these reasons it is not necessary for the protection of Telstra's legitimate business interests that access prices be increased to allow for cost recovery.[35] Even if this were true, clearly the Fixed Principles do not allow for adjustments to the cost-based pricing method to account for these types of factors. The Fixed Principles do not allow adjustments to the RAB or revenue allowance to account for declining demand, or to account for things that may be seen as compensation for declining demand. Turning to the specific factual claims made in submissions: • as noted by Mr Balchin, any 'compensation' to Telstra through its mobile business is likely to be incomplete and short-lived. Given that mobile services are supplied in a competitive market, it is likely that any additional revenue earned from mobile services will only just be sufficient to cover the incremental cost of serving new customers; • as noted in the body of this submission, the ACCC cannot form the view that it cannot simply be asserted that NBN payments compensate Telstra for any adjustments to the RAB or the allocation factors (outside of those permitted by the Fixed Principles), without evidence. As has previously been explained, Telstra's acceptance of the commercial deal with NBN Co was not on the basis that it would adequately "compensate" for the decline in demand for line services associated with migration of customers to the NBN and/or potential stranding of fixed line network assets. Rather, the reason for Telstra shareholders accepting the proposed deal was that on balance, this was preferable to not accepting the deal and being forced to compete with NBN Co.
It is relevant to compare to international benchmarks	Optus' submission includes comparisons of fixed line service prices (and also the Telstra Group's EBITDA performance) with overseas benchmarks.[36] These comparisons do not control for factors which may impact on the cost of supply, such as line density or input costs. Such comparisons are not relevant to the determination of fixed line services prices, set in accordance with the Fixed Principles. Further, as has been observed by the Australian Competition Tribunal, in order for any weight to be placed on benchmarks, it would be necessary to know much more about the features of each jurisdiction.[37]

[35] iiNet submission p, 8.
[36] Optus submission, pp 3-4.
[37] *Re Telstra Corporation Ltd (No 3)* [2007] ACompT 3, [385].

Appendix 2: Expert report of Mr Jeff Balchin

Provided as a separate document