TELSTRA'S SUBMISSION TO THE ACCC'S DRAFT DECISION ON PRIMARY PRICES IN THE FIXED LINE SERVICES FINAL ACCESS DETERMINATION

PLAIN ENGLISH SUMMARY

FINAL ACCESS DETERMINATION

In making a Final Access Determination (FAD) that sets regulated prices for the next five years across seven different services that provide wholesale access to Telstra's copper network, the Australian Competition and Consumer Commission (ACCC) is undertaking a large and complicated task.[1]

Making the determination involves the ACCC forecasting Telstra's operating and capital costs for a complex national network with numerous different elements that support voice and broadband services to millions of homes and businesses, as well as ensuring these costs are allocated equally across Telstra Retail and Wholesale customers. The ACCC must complete this task at a time of unprecedented change for the telecommunications industry with the migration to the National Broadband Network (NBN) which will involve millions of services moving off the regulated copper network.

Given the complexities involved and the changing nature of the industry, Telstra has focused on two core objectives in approaching the FAD:

1. We want a fair outcome from the Fixed Line Services review that provides real pricing certainty for all users of the copper network. We do not want our retail customers or industry to face the shock of significant price changes for services delivered over our copper network.

2. Consistent with the ACCC's own fixed principles,[2] Telstra must be provided with the opportunity to recover our costs of operating and providing access to our copper network across all users of the network.

These objectives remain at the core of our approach to the draft FAD primary prices.

TELSTRA'S INPUT

We have supported the ACCC through the FAD process by providing significant volumes of data on all elements of our network expenditure and demand forecasts, which they need to develop their building block pricing model. Since the ACCC made its draft FAD at the start of the year, we have provided more than 1,000 pages of additional information to address further questions the ACCC have raised about the operation of Telstra's copper network.

For our expenditure forecasts in particular, we have provided detailed and disaggregated information on our network costs and operations, and how the cost and use of the network is expected to change from now until 2019. This input is based on prudent and efficient costs, and reflects a highly conservative view of the actual cost to Telstra of operating and maintaining the fixed line network.

A SOUND FRAMEWORK

The ACCC's draft FAD provided a sound framework for setting prices for wholesale access to the copper network. Based on the ACCC's building block model, the draft establishes a fully allocated cost approach so that regulated prices should reflect all the costs associated with operating the network. This is the fairest approach and puts the ACCC in the best position to achieve the objective that all users of Telstra's network bear the costs of operating the network equally.

The ACCC draft also said changes to regulated prices should be smoothed across the seven different regulated services. This will deliver relative stability in pricing outcomes between the different wholesale services, which will in turn help support the efficient migration of end-users to the NBN by providing a stable set of pricing incentives for wholesale access seekers on Telstra's legacy network.

1. The seven services are called Unconditioned Local Loop Services (ULLS), Line Sharing Service (LSS), Wholesale Line Rental (WLR), Local Carriage Service (LCS), Public Switched Telephone Network (PSTN) Originating Access, PSTN Terminating Access and Wholesale ADSL.

2. The ACCC has established core fixed pricing principles to guide its decision making when determining what the wholesale prices should be to access Telstra's network. These principles state that Telstra must be given the opportunity to recover our costs fairly across all users of the network.

APPLYING THE FRAMEWORK

While the ACCC has established a sound framework for the FAD, some important adjustments are required to how the framework is applied for it to deliver a fair outcome consistent with the ACCC's fixed pricing principles. We believe the ACCC needs to revisit some important areas, including how to treat network assets in areas where NBN migration is underway, the cost of capital used, NBN-related expenditure relating to duct remediation and asset lives among other things. These matters are covered in detail in the submission, but the first two of these issues is considered below.

INCORRECTLY DISPOSING OF ASSETS

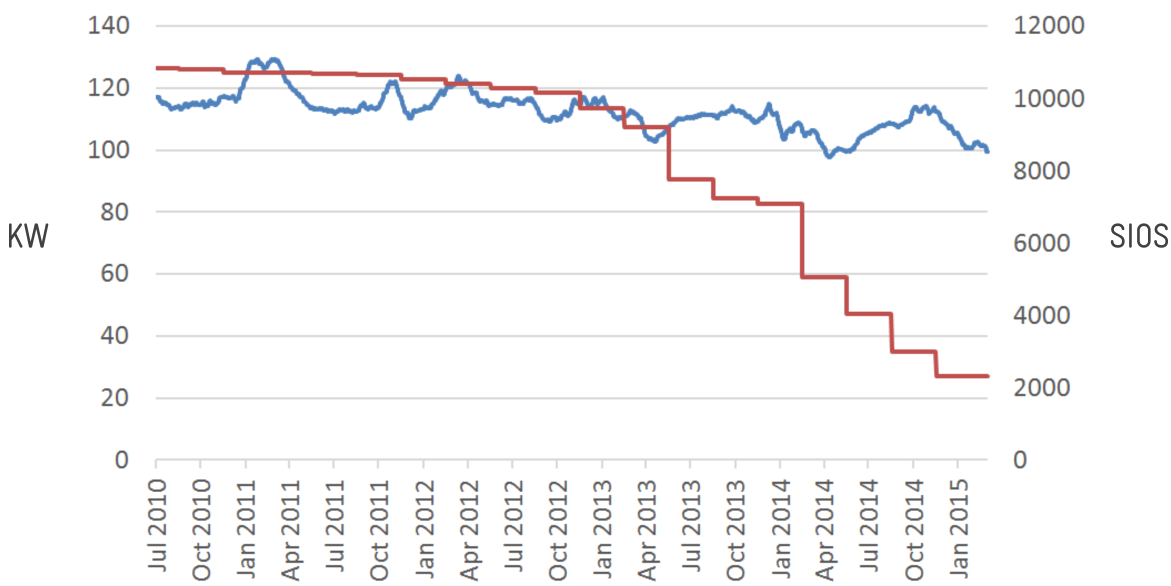
The draft decision correctly writes out of Telstra's asset base network assets which are transferred to NBN Co as the NBN is rolled out. However, it also proposed to write off hundreds of millions of dollars of assets which continue to be owned and operated by Telstra on the basis that the assets will support fewer services in the years ahead in areas where NBN Co rolls out its network.

This fails to recognise NBN Co is not systematically overbuilding entire Telstra exchange areas as it rolls out. Rather, NBN Co's rollout is more mosaic in nature, with rollout regions initially covering only parts of exchange areas and the copper network still needed for certain circumstances (e.g. Special Services and non-premises). Telstra will therefore need to continue to operate and maintain many network assets until later in the NBN rollout when a full exchange area is complete and all services can be migrated. Telstra's costs associated with these assets therefore do not fall at the same rate as usage is forecast to decline from the NBN migration.

Telstra's more than 5,000 Exchange sites, as well as network equipment such as DSLAMs and switching equipment, are not expected to reduce materially over the next five years. In order for services still connected to the copper network to operate for end-users, Telstra must incur a significant amount of fixed costs – such as maintenance, power, rent etc, and there is no way in the real world to 'optimise' these costs away as the ACCC has assumed in the draft decision. These costs are legitimately and prudently incurred and Telstra should be entitled to recover them equally across all users of the network. Moreover, Telstra does not receive any compensation for these costs under the NBN deal

As this example of power costs from Telstra's Exchange in Armidale (NSW) shows, the existence of the NBN and the migration of customers to the new network does not lead to all costs falling at the same rate.

ARMIDALE EXCHANGE POWER USAGE (KW) V NUMBER OF SERVICES IN OPERATION (SIO)



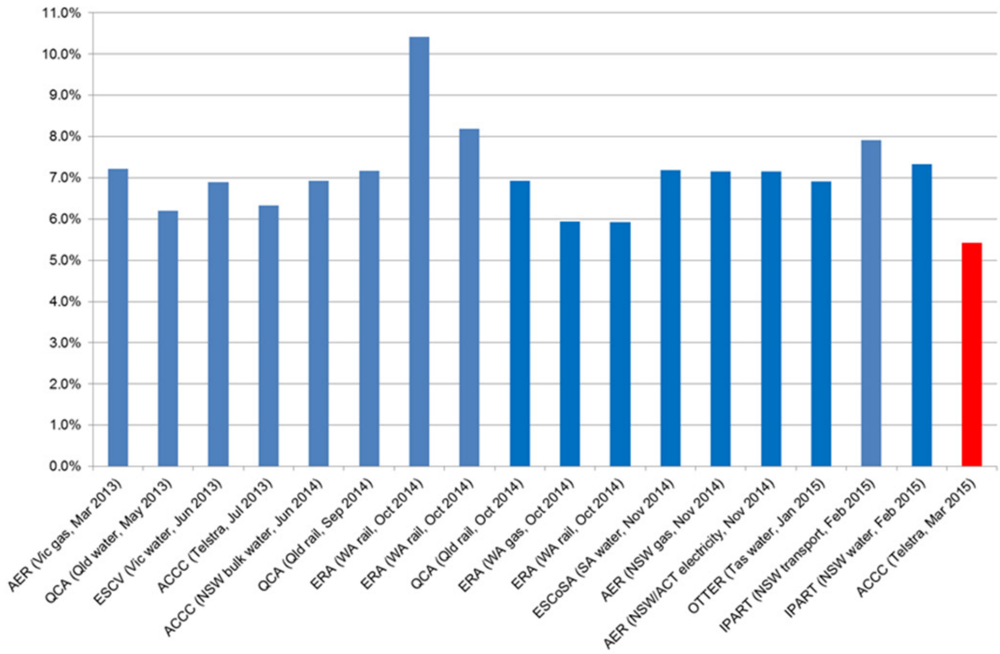
COST OF CAPITAL UNREALISTICALLY LOW

The cost of capital provided to Telstra in the ACCC's draft decision is by far the lowest set by any Australian regulator for a major regulated business in the past two years. Our concern is that if the ACCC applies an unrealistically low cost of capital they would distort the pricing decisions in the FAD.

The draft FAD implied Telstra faces less risk and lower capital costs than other regulated companies, including water utilities, public transport operators and energy businesses. On any reasonable view this can't be correct – it is even inconsistent with the ACCC's own statements regarding the uncertainty Telstra and other telecommunications companies face during the rollout of the NBN.

The draft cost of debt also did not reflect Telstra's actual costs, which have been confirmed since the draft decision by Telstra's bond issue of $1 billion in April 2015, which was more than twice the cost of debt proposed by the ACCC.

RECENT WEIGHTED COST OF CAPITAL DECISIONS BY REGULATORS



CONCLUSION

We are confident that shortcomings in the draft FAD can be addressed given that in using a building block model and fully allocated cost approach the ACCC has adopted an overall framework that is sound and practical. This is a strong basis to complete the FAD and we look forward to working with the ACCC has they move through the final stages of the process.

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