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Mr Michael Cosgrave
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Australian Competition and Consumer Commission
Level 35, 360 Elizabeth Street
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Dear Mr Cosgrave

Telstra's Band 2 ULLS undertaking

On 13 November 2008, the ACCC published a Draft Decision assessing Telstra's Band 2 ULLS undertaking (**Undertaking**) and rejecting the same. Generally speaking, the ACCC's Draft Decision rejected the Undertaking on the basis that the ACCC was not satisfied the terms and conditions of the Undertaking were reasonable. The ACCC has called for submissions in response to its Draft Decision rejecting the Undertaking by 12 December 2008.

In developing the TEA model, it has been Telstra's practice to elicit criticisms of the TEA model and suggestions for improvement at every stage of the development process. Each and every criticism and suggestion has been analysed and, where appropriate, acted upon. Telstra views the ACCC's Draft Decision as another stage in the TEA model development process and wishes to respond, as it has in the past, by making changes to the model where necessary and appropriate. As such, Telstra wishes to fully understand, analyse and respond to the ACCC's criticisms and recommendations in the ACCC's Draft Decision.

Additionally, as the ACCC is aware, Telstra bears the burden of satisfying the ACCC of the reasonableness of the terms and conditions of the Undertaking in order for the ACCC to decide to accept the Undertaking. The reason for publishing the Draft decision is to inform Telstra and others of the ACCC's views on the Undertaking and to afford them the opportunity to put on further submissions and evidence, in Telstra's case, so as to discharge its burden of satisfying the ACCC of the reasonableness of the Undertaking.

However, there are, in Telstra's view, a number of aspects of the ACCC's Draft Decision which require clarification in order for Telstra to adequately analyse the ACCC's criticisms and respond to the ACCC's Draft Decision. As the ACCC is aware, Telstra is entitled to have an opportunity to ascertain, understand and respond to any issues of relevance to the ACCC in making its decision in relation to the Undertaking. If Telstra is not afforded that opportunity because of the lack of clarity in the Draft Decision then Telstra will have been deprived of the object of publishing the Draft Decision

In addition to the above, Telstra considers there are a number of aspects of the ACCC's Draft Decision where the ACCC does not set out in adequate detail the ACCC's consideration of particular issues in reaching its conclusions. The Federal Court of Australia's recent decision in *Telstra v ACCC & Anor* [2008] FCA 1758 clearly states that, in circumstances where the ACCC is required by the words of the TPA to "*have regard* *to…*" a particular matter, the ACCC must give that matter weight as a "*fundamental element in making* [its] *determination".*

Given section 152CR of the TPA (the provision under consideration by the Federal Court) is largely identical to section 152AH, in the context of the Undertaking, the ACCC is similarly required to give weight as a '*fundamental element in making* [its decision on the Undertaking]' to the matters listed in ss152AH(1)(a) – (f) (without limitation). This requires the ACCC to have regard to the matters set out in s152AH(1):

> "*by giving them proper, genuine and realistic consideration…A mere recitation of submissions to* [the ACCC] *and then the expression of an unreasoned conclusion could not suffice to comply with the Commission's obligation…"*

Telstra considers the ACCC's obligation summarised above has not been satisfied in a number of aspects of the ACCC's Draft Decision.

For the reasons explained above, therefore, Telstra attaches list of questions in relation to the Draft Decision for the ACCC's response.

Telstra considers answers to the questions below are required from the ACCC in order for Telstra to fully understand, address and respond to the ACCC's Draft Decision and to satisfy the ACCC that Telstra's Undertaking is reasonable.

Yours sincerely,

Tony Warren
Executive Director Regulatory Affairs
Public Policy and Communications

LIST OF QUESTIONS IN RELATION TO THE DRAFT DECISION

DESIGN OF THE TEA MODEL

Telstra requires clarification/explanation from the ACCC, with regard to the design of the TEA model as opposed to the model's inputs, in order to fully address the ACCC's concerns. For instance, the ACCC has found that the TEA model is not fully optimised; but it is unclear to Telstra what further optimisation the ACCC believes is possible and necessary.

> "*However, the ACCC is not satisfied that the TEA model reflects efficiency savings.*" [Draft decision, at page 40]

> "*The ACCC considers that given the starting point of scorched node and the need to model a copper network, the TEA model is broadly based on a best practice engineering rules and practices. However design and implementation issues mean the extent of the efficiencies in the model is not as extensive as claimed by Telstra. The ACCC also notes that Telstra's application of its TEA model does not incorporate all efficiencies and optimisations that would be theoretically possible using efficient forward-looking technology.*" [Draft decision, at page 72]

Telstra assumes the "*design and implementation issues*" referenced by the ACCC are those raised in the Ovum report. Telstra has already modified the TEA model in response to Ovum's report to fix a problem with the optimisation of the main network. Further, Telstra is addressing Ovum's criticism of the distribution network optimisation in a response to the Ovum submission. In that response Telstra explains that Ovum's concern regarding distribution areas that abut and "overlap" one another is unfounded because elimination of shared trenching between distribution areas would increase cost rather that result in increased efficiency. In any event, Ovum's concern only relates to 0.51% of distribution trench length.

Beyond these two design and implementation issues cited by Ovum, which have already been addressed by Telstra, it is not clear which efficiencies and optimisations the ACCC would like Telstra to address. Telstra is entitled to respond to further ACCC concerns in the same manner it has responded to all past concerns expressed by the ACCC, with thorough analysis and appropriate modifications to model design.

To that end, Telstra ask that the ACCC provide clarification/explanation regarding which optimisations and efficiencies it would like included in the TEA model design?

The ACCC also states:

> "*The ACCC notes that when Telstra developed the TEA model it sought to use actual costs incurred as a basis for determining efficient forward looking costs.*" [Draft decision, at page 80]

> "*…as the TEA Model reflects Telstra's actual network, this suggests that the model has not been implemented using the most efficient network build.*" [Draft decision, at page 71].

> "*Further, the ACCC's view is that where access prices are based on actual network costs, rather than the costs of an efficient network, the resulting access prices will not reflect the efficient costs of providing the service and will not encourage appropriate build/buy decisions. Therefore, the object of promoting efficient investment is not achieved when costs of Telstra's existing network, without taking*

> *account of efficiency savings, are used to determine costs of providing the ULLS."* [Draft decision, at page 71]

Telstra has advocated use of actual geographic and topological conditions as a basis for estimation of efficient forward-looking costs, not cost incurred (some O&M factors are based upon actual cost, but those are variable inputs not elements of model design).

Does the ACCC believe the TEA model is based upon and reflects actual network costs?

If so, could the ACCC clarify/explain in what manner does the TEA model produce results which reflect actual network costs rather than forward looking efficient costs?

The ACCC states:

> "*The ACCC notes that Telstra has provided material to show that the TEA model network design is more efficient than Telstra's actual network but no evidence is provided to show the likely efficiency savings were the TEA model compared with a fully optimised network."*[Draft decision, at page 40]

Telstra has recently lodged a submission titled *TEA Model Route Optimisation Process*, which explains how the TEA model optimises Telstra's actual network routes.

Could the ACCC clarify/explain whether it continues to hold its view expressed in the draft decision that the TEA model reflects Telstra's actual network given the recently lodged submission titled *TEA Model Route Optimisation Process*?

If not, could the ACCC clarify/explain what additional evidence would be required to satisfy the ACCC that the TEA model is fully optimised?

TRENCHING COST INPUTS

Telstra also requires clarification/explanation from the ACCC in order to appropriately respond to the ACCC's findings with respect to trenching costs and trench sharing. The ACCC has clearly stated that prices that reflect forward-looking efficient costs meet the legislative criterion for evaluation of an Undertaking.

> "*The ACCC considers that ULLS access prices that reflect the efficient (as opposed to actual) cost of supplying the ULLS will best promote the LTIE."* [Draft decision, at page 47]

> "*The ACCC considers that prices that reflect efficient forward-looking costs of supply will best promote effective competition in the supply of fixed-line voice services and broadband/DSL services in the present environment."* [Draft decision, at 48]

> "*The ACCC considers that an access price that reflects efficient, forward-looking costs best meet [sic] the objective of encouraging the economically efficient use of and investment in infrastructure."* [Draft decision, at page 50]

> "*The ACCC's view is that where access prices are based on costs that are not the costs of a fully optimised and efficient network, the resulting access prices may not reflect the efficient costs of providing the service and will not encourage appropriate build/buy decisions. On this basis the ACCC considers that the objective of promoting efficient investment is not achieved when costs of providing the ULLS are based on a*

> *network which has not been fully optimised and does not use forward looking and efficient cost values."* [Draft decision, at page 51]
>
> "*The ACCC considers that, in the context of access prices, prices that reflect the efficient forward-looking costs of the service best meet this criterion."* [Draft decision, at page 56 in reference to economically efficient operation of a carriage service]

Yet the ACCC seems to find that there are exceptions to this rule. The ACCC appears to have a "*cost incurred*" exception to its finding that forward-looking efficient costs, rather than actual costs, best meet legislative criterion.

> "*However, the ACCC recognises that there will be sets of circumstances where forward-looking costs do not adequately promote the objectives of the criteria that the ACCC must have regard for in determining whether the undertaking is reasonable. The ACCC is of the view that this is such a circumstance.*
>
> *Telstra has proposed that forward-looking costs should include the retrenching and repaving of trenches where local copper pairs were initially laid. However, the ACCC agrees with Optus submission that Telstra did not incur trenching costs of the same magnitude as those modelled in the TEA model since, for example housing estate developers excavated many of the trenches which Telstra use (footnote omitted). Therefore by allowing Telstra to include these cost as part of the TEA model would result in Telstra being compensated for costs that it (in most cases) never incurred and is not likely to incur within the economic life of the existing copper pairs."* [Draft decision, at page 80]
>
> "*In conclusion, the ACCC believes that the inclusion of trenching costs, where they have not been incurred by Telstra, will lead to access prices which discriminate between access seekers and access providers which is not in the LTIE."* [Draft decision, at pages 80-81]

The ACCC also seems to have adopted a "*realities of network deployment*" exception to its pricing standard, which relies upon the application of "*cumulative (historic)*" measures of cost.

> "*The ACCC considers that, when applying the TSLRIC framework in a practical sense, forward looking network costs need to reflect the realities of network deployment and that it is not possible for the CAN to be constructed in one period (or instantaneously). The ACCC view is that network construction would generally be planned a significant time in advance and would most likely occur in conjunction with other operators and utility providers resulting in the use of open trenches in new estates at no cost to Telstra. The ACCC considers that based on a pragmatic application of TSLRIC, it is appropriate to maintain its position that the best available proxy for trench sharing in new estates is the cumulative (historic) trench sharing measure. In this regard the ACCC considers that a trenching sharing value of between 13-17 per cent approximates cumulative trench sharing potential in new estates."* [Draft decision, at page 87]

In order to thoroughly analyse and fully respond to the ACCC's "*costs incurred*" and "*realities of network deployment*" pricing standards, Telstra requires the following clarifications.

Does the ACCC find that actual historic costs of trenching should be included in Telstra's cost study?

Should Telstra's access pricing be based upon actual incurred costs or forward-looking efficient costs?

Is it the ACCC's view that the "*proxy for trench sharing in new estates*" is made to mimic a forward-looking estimate of the costs of a new network build over time?

Should Telstra apply the "*realities of network deployment*" exception to include cumulative (historic) measures of necessary network reinforcement and stranded investment costs in its study due to the realities of shifting demand over time?

Referring to page 53 of the draft decision, could the ACCC clarify/explain the basis and evidence relied upon for the sentence "*In a substantial majority of cases, local copper pairs were installed in turf and only subsequently paved over*"?

USE OF TSLRIC+

The ACCC states:

> *"However, the ACCC acknowledges that the past rationale of promoting efficient build/buy decisions through the application of TSLRIC+ may be less relevant in a regulatory environment where the competitive state of telecommunications markets is changing and there may be fewer prospects for efficient by-pass. If the rolling out of fibre closer to the customer makes the prospects of efficient duplication more remote, then some of the key rationales for a TSLRIC+ approach to pricing will be less relevant."* [Draft decision, at page 34]

Could the ACCC clarify/explain what has changed since 21 November 2007, when the ACCC found TSLRIC+ should be applied to the ULLS in the ACCC's 2007 ULLS pricing principles determination?

DIRECT COSTS

Could the ACCC explain/provide the workings and analysis underlying the information in Table 6.1 of the draft decision?

VARIABLE INPUTS

The ACCC states:

> *"The ACCC also notes that Telstra has asserted that the Proposed Monthly Charge can be supported by the results of the TEA model under any reasonable set of inputs. The ACCC has found that when the TEA model is run with* ***other parameter values****, the resulting range of monthly charge estimates are significantly less than $30. This leaves the ACCC with significant doubt as to whether the Proposed Monthly Charge of $30 is reasonable."* [Emphasis added, Draft decision, at page 41]

Could the ACCC provide the excel spreadsheets or other computer model runs which were performed by the ACCC in running its scenarios with "*other parameter values*", which led the ACCC to conclude that there is "*significant doubt as to whether the Proposed Monthly Charge of $30 is reasonable*"?

Further, the ACCC says it ran the model with "*other parameter values*" but it does not say whether those parameters are reasonable.

Does the ACCC consider the "*other parameter values*" relied upon in its determination to be a reasonable set of inputs?

In any case, could the ACCC provide a complete set of values for inputs into the TEA model that it used in arriving at its draft decision to reject the Undertaking?

In relation to entrance facilities, the ACCC states:

> *"The ACCC also notes that the TEA model includes entrance facility costs to total network costs. These costs should not be included in total network costs of providing the ULLS as these costs are already recovered in TEBA charges."* [Draft decision, at page 76]

Telstra does not believe that these costs are recovered in TEBA charges and would appreciate clarification/explanation of the source for this assertion.

In relation to asset lives, the ACCC states:

> *"However, the ACCC believes that asset lives need to primarily be determined by their expected operational (physical) life. As such, while the regulatory asset lives might be less than the physical asset lives, they should not be substantially less."* [Draft decision, at page 123]
>
> *"The ACCC considers the asset lives proposed by Telstra, particularly for copper cables and ducts and pipes, appear to include an obsolescence factor consistent with a possible replacement by next generation technology, and as such are not reflective of the physical life of copper network assets."* [Draft decision, at page 124]

Could the ACCC clarify/explain whether this conclusion means that the ACCC no longer considers economic asset lives to be appropriate and considers that regard should only be had to the operational (physical) lives of assets?

Can the ACCC clarify/explain why it believes that next generation technology would not affect the operational (physical) lives of assets?

In relation to asset prices, the ACCC states:

> *Ovum states that there is no evidence that the network costs submitted in the model have been re-valued and made forward looking. Further, Ovum concludes that the cost inputs are in fact generally historic averaged costs sourced from Telstra's engineering department and mainly drawn from three Access and Associated Services ("A&AS") agreements.* [Draft decision, at page 74]
>
> And
>
> *Ovum concludes that the other equipment prices in the TEA model should be lower as they should be valued at current cost of a modern equivalent assets and if the cable costs are adjusted with international benchmarks and other equipment prices are reduced by 10 per cent, then the final ULLS cost falls by 6 per cent.* [Draft decision, at page 75]

As can be read from their submission (at section 2.2), Ovum's suggestion to reduce equipment prices by 10% is made on the basis of its view that the vendor prices in the TEA model are historical, they need to be adjusted by price trends and that equipment prices have fallen by 5-15% per annum.

However, such an adjustment would be inconsistent with the ACCC's statement in relation to the tilted annuity:

> *The ACCC's analysis indicates that an economically significant positive tilt should be applied to the value of the ULLS, in aggregate, since the value of the ULLS lines and trenches and ducts are expected to be valued significantly higher in the future in nominal terms.* [Draft decision, at page 123]

Could the ACCC please confirm if it gives weight to Ovum's conclusion that the vendor prices in the TEA model, for trenching and ducting specifically, are historical costs, particularly with regard to Telstra's evidence that vendor prices are current?

If so, could the ACCC please confirm whether it considers it reasonable to carry the vendor prices in the TEA model forward one year, with the ACCC's price trends, as Ovum has suggested is appropriate?

In relation to trench sharing in new estates, the ACCC states:

> ***"…a trench sharing value of between 13-17 per cent approximates cumulative trench sharing potential in new estates"*** [Draft decision, at page 87]

What is the precise basis for the ACCC's estimate that "*a trench sharing value of between 13-17 per cent approximates cumulative trench sharing potential in new estates*" and please clarify/explain how the calculation of the percentages was performed?

Does the ACCC consider that a band 2 measure of the "*cumulative trench sharing potential in new estates*" would be more appropriate for a band 2 cost model, rather than a national estimate?

Referring to page 76 of the draft decision, what precise categories of equipment are priced too high and what does the ACCC consider to be an appropriate cost for that equipment?

INTERNATIONAL BENCHMARKING

Referring to page 42 of the draft decision, can the ACCC please provide all the documents used by the ACCC in its international benchmarking including the adjustment made to the Ovum report referenced in footnote 70 to convert the prices into Australian dollars?

Does the ACCC take the concept of purchasing power parity into consideration in its determination? How is purchasing power parity calculated?

Note that Telstra has been sent the raw Ovum data.

The raw Ovum data relied upon by the ACCC appears to have no supporting documents or references. Telstra would like to verify the sources of this data and the accuracy with which that data has been compiled and compared.

Could the ACCC please have Ovum supply Telstra with materials and references underlying the raw Ovum data?

DEPRECIATION

The ACCC states:

> "*The ACCC considers that if a zero tilt is applied then Telstra may receive an abnormal return when its assets are re-valued upwards in future regulatory periods in response to price trends. In particular, Telstra will receive ex-ante over compensation due to the expectation of this revaluation.*" [Draft decision, at page 123]

Please clarify/explain the extent to which the ACCC considers prior and future regulatory periods should be considered in the calculation of the appropriate level of compensation for access services during Telstra's undertaking period, so that Telstra can have proper regard to these factors in its pricing proposal.

Please clarify/explain whether the ACCC considers Telstra should have regard to any under recovery of either direct cost or TSLRIC+ in the provision of ULLS in prior regulatory periods in the pricing of ULLS during the period the Undertaking will be in effect?