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

Discussion Paper - July 2014

Submission by iiNet Limited

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1. INTRODUCTION

This submission is made by iiNet Limited (**iiNet**) in response to the discussion paper entitled: *Public inquiry into final access determinations for fixed line service — primary price terms* (**the Discussion Paper**).

The Australian Competition and Consumer Commission (**ACCC**) is currently undertaking public inquiries into making new final access determinations (**FADs**) for:

- the six fixed line services[1]; and
- the Wholesale ADSL service (**WDSL**),

  (**the Declared Services**).

The current FADs for the Declared Services specify certain price and non-price terms and conditions. The ACCC has divided the price terms into two categories:

- **Primary prices** - these are charges for direct use of the services, that is:
  - the monthly access prices for the ULLS, LSS, WLR and wholesale ADSL port service; and
  - the usage charges for the LCS, FOAS and FTAS and wholesale ADSL AGVC service.
- **Supplementary prices** - these refer to additional charges incurred in using the Declared Services, for example, connection and disconnection charges.

Due to the complexity and number of issues involved in determining the primary prices for the Declared Services, the ACCC has decided to consult separately on:

- the primary prices for the Declared Services; and
- the non-price terms and supplementary prices for the Declared Services.

The Discussion Paper deals with the primary price terms for the Declared Services.

iiNet welcomes the opportunity to respond to the Discussion Paper.

[1] These are: the Local Call Service (**LCS**), Line Sharing Service (**LSS**), the Fixed Originating Access Service (**FOAS**), the Fixed Terminating Access Service (**FTAS**), the Unconditioned Local Loop Service (**ULLS**) and the Wholesale Line Rental Service (**WLR**).

2. OVERVIEW OF THIS SUBMISSION

Having considered the issues raised in the Discussion Paper, iiNet has come to the following conclusions:

- The ACCC should not lose sight of outcomes. This issue is considered in section 4 below.
- Under the current circumstances, an increase in prices for the Declared Services would be an irrational outcome. This means that Telstra's proposed cost allocation framework (**CAF**) cannot be accepted in its current form. This issue is considered in section 5 below.
- Lower access prices are the most appropriate outcome and should not be feared. This issue is considered in section 6 below.
- The ACCC should consider, and give appropriate weight to, the outputs of its current costs model rolled forward. This issue is considered in section 7 below.
- It is appropriate for Telstra to continue to bear the impacts of declining demand. This issue is considered in section 8 below.
- There is no justification for determining a range of prices for the declared fixed line services outside the FLSM. This issue is considered in section 9 below.
- There is a need for close scrutiny of Telstra's forecasts. This issue is considered in section 10 below.

This submission provides the basis for the above conclusions. On the basis of the above conclusions, iiNet has reached an overall conclusion that, in terms of outcomes, a reduction in access prices for the Declared Services would be the most appropriate outcome.

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3. EXECUTIVE SUMMARY

There is a danger that this inquiry is getting choked in the minutiae of issues that relate to cost modelling methodology. In iiNet's view, what is required is a re-alignment of focus so that the central focus of this inquiry is outcome based. Otherwise there is a real risk that the tail will wag the dog. Public comments from Telstra and some political sources appear to be attempts at 'conditioning' the public to increased retail charges, contrary to trends for telecommunications costs, generally.

When focus is put on outcomes, it quickly becomes apparent that an outcome where access prices are increased for legacy services is irrational in circumstances where Telstra has no incentive to invest in the legacy network and Telstra is being compensated by NBN Co for falling demand caused by the NBN. If the central focus is put on outcomes, it becomes clear that the CAF (an application of which leads to higher access prices for the Declared Services) cannot be accepted in its current form. Higher prices for end users for legacy services simply cannot be justified under the current circumstances.

iiNet submits that when the causes of declining demand are considered, it is appropriate that Telstra continues to bear the impacts of declining demand. In particular, a pragmatic way to implement adjustments to the 'regulatory value' of assets decommissioned or utilised to a lesser extent as a result of the NBN migration is to adjust the regulated cost base in a way that offsets the fall in demand caused by the NBN.

The fears that have been expressed about the effects of lower access prices are unfounded. Lower access prices are the most appropriate outcome under the current circumstances. This means that the central question remaining at the heart of this inquiry is:

By how much should access prices for the Declared Services be reduced?

iiNet believes that when considering this question, the ACCC needs to give appropriate weight to the outputs that result when the current fixed line services model (**FLSM**) is rolled forward. The ACCC also needs to give further scrutiny to Telstra's forecasts and to give stakeholders a reasonable opportunity to scrutinize Telstra's revised forecasts and the assumptions on which they are based.

This process should not begin with Telstra's assumption that their revenues must be protected at the expense of all other stakeholders.

4. THE ACCC SHOULD NOT LOSE SIGHT OF OUTCOMES

iiNet is concerned that there is a real risk that this inquiry is getting choked with the minutiae of Telstra's proposed cost allocation framework, and in doing so, is losing sight of the bigger picture.

At the heart of this inquiry is the following question:

> *What should the access prices for the Declared Services be during the next regulatory period?*

iiNet acknowledges that this question raises complex issues. Nevertheless, it is important to acknowledge that, in broad terms, there are only three possible outcomes:

- access prices go down;
- access prices go up; or
- access prices stay the same.

Therefore, what the ACCC must ultimately consider is which of these three outcomes is most appropriate under the current circumstances. In determining which outcome is most appropriate the ACCC must have regard to the following matters:[2]

- the objective or promoting the long-term interests of end-users (**LTIE**);
- the legitimate business interests of the access provider;
- the interests of all persons who have rights to use the declared service;
- the direct costs of providing access to the declared service;
- the value to a person of extensions, or enhancement of capability, whose cost is borne by someone else;
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility; and
- the economically efficient operation of a carriage service, a telecommunications network or a facility.

The ACCC may also take into account any other matters that it thinks are relevant.[3]

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[2] Section 152BCA (1) of the Competition and Consumer Act 2010.
[3] Section 152BCA (3) of the Competition and Consumer Act 2010.

5. UNDER THE CURRENT CIRCUMSTANCES AN INCREASE IN ACCESS PRICES FOR THE DECLARED SERVICES WOULD BE AN IRRATIONAL OUTCOME

Before considering the relevant current circumstances, it is useful to have regard to the following hypothetical scenario:

> *NBN Co and Telstra are competing with each other. NBN Co has overbuilt Telstra's network and is able to offer faster services than Telstra. Demand for Telstra's services is falling.*

In this scenario Telstra has two rational choices (assuming Telstra wants to remain in the market):

- It can invest in its network so that it can compete with NBN Co on the basis of quality (for ease of expression, this will be referred to as **the Investment Decision**).
- It can accept that its services are inferior but it can attempt to compete on the basis of price – i.e. offer cheaper services than NBN Co (for ease of expression this will be referred to as the **Price Decision**).

If Telstra makes the Investment Decision, then it would be rational for access prices to rise in order to allow Telstra to recover the costs of its investment. On the other hand, if Telstra makes the Price Decision, Telstra would be seeking to keep its prices as low as possible and, as a result, would likely seek to reduce investment in its network to the minimum possible level (i.e. Telstra would still need to keep the network running and ensure that the quality of its services is not reduced too far but it would not make any additional investments). Without upgrading its network, any increase in price by Telstra would likely result in a 'death spiral' and would be irrational.

Returning to the real world, as far as investment in the legacy network is concerned, Telstra having agreed not to compete with NBN Co, effectively puts Telstra in the position of having made the Price Decision – i.e. Telstra has very little incentive to do anything other than make the minimum possible investments in the legacy network. Given that Telstra is being compensated by NBN Co for the effects of falling demand caused by the NBN, higher access prices that account for the fall in demand caused by the NBN will simply provide Telstra with a windfall via regulated protectionism (this is considered further in section 8.2 below).

As far as the relevant statutory test is concerned, iiNet submits that Telstra obtaining a windfall:

- does not promote the LTIE; and
- is not required to satisfy Telstra's legitimate business interests.

When considering promotion of the LTIE, the ACCC must consider the following objectives:[4]

- Promoting competition.

[4] Section 152AB of the Competition and Consumer Act 2010.

- Promoting efficient use of, and investment in, infrastructure.
- Achieving any to any connectivity.

Achieving any to any connectivity is largely irrelevant here and will not be considered further. The other two LTIE objectives are considered in turn. Telstra's legitimate business interests are then considered.

5.1 Promoting competition

If prices are increased, access seekers would be required either to:

- absorb the price increases; or
- pass them on to end users.

Providing Telstra with protection, and a windfall through higher access prices, would give Telstra a significant advantage over and above its current dominant market position because Telstra would be in a position where it could set and keep its retail prices lower than access seekers' retail prices and aggressively win market share during the transition to the NBN.

Indeed, the outcome of Telstra's approach is that at a time when access seekers face higher prices, Telstra's cash costs – operating and capital expenditure - are falling. Putting up access prices to facilitate the recovery of sunk costs runs the risk of undoing the modest strides made by access seekers in the last 10 years, and it is likely to have repercussions for many years to come. At the risk of mixing metaphors, iiNet believes that creating such an uneven playing field between Telstra and access seekers would represent a hit on access seekers that is below the belt.

Furthermore, when considering the LTIE more broadly, iiNet submits that an access pricing decision that leads to a real risk of end users paying higher prices for legacy services simply cannot promote the LTIE in circumstances where those higher prices are not required to recover, or encourage, investments in order to allow better services to be developed. The following observation of the Australian Competition Tribunal is pertinent here:[5]

> *the interests of end-users lie in obtaining lower prices (than would otherwise be the case), increased quality of service and increased diversity and scope in product offerings.*

5.2 Promoting efficient use of, and investment in, infrastructure

As discussed above, Telstra already has no incentive to do anything other than make the minimum investments in the legacy network. Therefore the objective of promoting investment in the legacy network should carry no weight in the current circumstances. Although iiNet acknowledges that higher access prices could theoretically encourage migration to the NBN (for example if access prices were increased to a level above NBN Co's prices), this consideration is outweighed by the following:

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[5] *Re Seven Network Limited (No 4)* [2004] ACompT 11, at [120]

- migration to the NBN is mandatory. Therefore, it is not necessary to incentivize migration to the NBN;
- the NBN is still being built. In the meantime, higher access prices will seriously damage competition and lead to a real risk of unnecessary price increases for end users; and
- it is entirely inconsistent with the LTIE to force migration by a mechanism of increased prices.

5.3 Telstra's legitimate business interests

The scope of Telstra's legitimate business interests is to allow Telstra to recover the costs of its investments and to earn a normal return on its investments.[6] Telstra's legitimate business interests do not extend to double recovery of costs or monopoly profits, or protection of revenues resulting from technical obsolescence. Given that Telstra is receiving compensation from NBN Co for migrating its customers to the NBN, satisfying Telstra's legitimate business interests does not require access prices to be increased so that Telstra receives either protection or an additional windfall.

5.4 Conclusion on higher access prices

A useful litmus test of regulated pricing is to consider whether the regulated pricing is consistent with pricing that would result in a competitive market. iiNet submits that, given that Telstra is effectively in the position of having made the Price Decision, increased access prices for the Declared Services would be inconsistent with the pricing that would result in a competitive market. iiNet submits that, given that higher access prices:

- would be inconsistent with the prices that would result in a competitive market;
- do not promote the LTIE; and
- are not required to satisfy Telstra's legitimate business interests,

an increase in access prices would be an irrational outcome to this pricing inquiry.

In light of the fact that higher access prices would be irrational under the current circumstances, the fact that Telstra's proposed CAF leads to higher access prices means that it cannot be accepted in its current form. 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. This is because, just as with access pricing more broadly, cost allocation is not an exact science. In this regard the following statement made by the ACCC in the context of setting the initial RAB value has resonance:[7]

> *The ACCC noted that there is no uniquely 'correct' value for the initial RAB. An element of judgement is therefore required to determine a suitable range of potential values for Telstra's sunk investment in network assets and then to settle on a value within this range that forms a sound basis for estimating prices.*

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[6] *Telstra Corporation Limited* [2006] ACompT 4 at [89].
[7] Inquiry to make final access determinations for the declared fixed line services Final Report July 2011, at p.37.

iiNet submits that, just as with the approach to determining the initial RAB value, it is possible that there may be more than one acceptable approach to cost allocation. Therefore, it is not essential to embark on a quest to find the 'one true' cost allocation approach. Rather, adopting an approach that is fit for purpose is all that is required. Given the irrational outcome that it delivers, Telstra's CAF is clearly not fit for purpose. In contrast to the CAF, the ACCC has already determined during the 2011 FAD inquiry that its current approach is fit for purpose (this is considered further in section 7 below).

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6. LOWER ACCESS PRICES SHOULD NOT BE FEARED

iiNet is aware that lower access prices for the Declared Services have been feared because they have been seen as having the potential to disrupt or delay migration to the NBN.[8] iiNet has two responses to this point. Firstly, Migration to the NBN is mandatory. Secondly, NBN services are superior to the legacy services. Therefore, some price differential is rational and to be expected (i.e. the selling point of the NBN is not 'you will get a cheaper service' it is 'you will get a better service'). Therefore, if an access seeker adopts a business plan that is based on trying to keep its customers on the legacy network for as long as possible, it will run the risk of losing customers to competitors who have seized the initiative and have embraced the superior service offerings that the NBN delivers (i.e. given the mandatory nature of the migration, churns between the legacy network and the NBN are only ever going to be in one direction).

iiNet believes that any issues regarding potential 'price shocks' (arising from the difference between prices for legacy services and NBN services) are not relevant to this pricing inquiry and are more appropriately considered in the context of pricing for NBN services. iiNet's direct experience to date with NBN take-up does not support the notion that such a price-shock will occur. There is no evidence to support such a notion. In this regard iiNet notes:

- NBN Co has at least 30 years to recover its investments (this means that any required glide path should be in respect of NBN pricing and not legacy network pricing);[9] and
- current NBN pricing is based on an FTTP rollout – i.e. the move to a multi-technology mix may allow price reductions without affecting NBN Co's bottom line.
- Customer take-up to date is clearly skewed towards the higher priced NBN options.

On the basis that:

- higher access prices are irrational under the current circumstances (see section 5 above); and
- there are no good reasons to fear lower access prices,

iiNet submits that lower access prices are the most appropriate outcome. iiNet believes that this conclusion is strengthened by the fact that (assuming reasonable forecasts from Telstra), lower prices are likely to be the outputs of the ACCC's current model (a model that was specifically designed to deliver outputs that are consistent with the statutory criteria) when rolled forward.

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[8] See for example : Final access determinations for fixed line services – primary price terms – Department of Communications submission to the Australian Competition and Consumer Commission – 3 October 2014.
[9] This is based on the term of NBN Co's current Special Access Undertaking.

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7. THE ACCC SHOULD CONSIDER, AND GIVE APPROPRIATE WEIGHT TO, THE OUTPUTS OF ITS CURRENT COSTS MODEL ROLLED FORWARD

The FSLM was designed to deliver outputs that are consistent with the applicable statutory criteria. The table below sets out the ACCC's analysis of its current cost allocation factors as against the statutory criteria:[10]

Section 152BCA(1) matter	ACCC conclusion
Paragraph 152BCA(1)(a) – whether the determination will promote the LTIE	The ACCC considers that the cost allocation factors used in the FLSM ensure that the efficiently incurred costs of providing the declared fixed line services are included in the revenue recovered from each of the declared fixed line services during the regulatory period. Setting prices that reflect efficient costs will promote competition in the markets for carriage services and encourage efficient use of and investment in infrastructure. The objective of achieving any-to-any connectivity is not relevant to determining the appropriate cost allocation factors as it does not affect connectivity between telecommunications networks.
Paragraph 152BCA(1)(b) – legitimate business interests of a carrier or carriage service provider	The ACCC considers that the cost allocation factors used in the FLSM to derive wholesale access prices will enable the access provider to recover its efficient costs of supplying access to the declared fixed line services. The ACCC considers that Telstra's legitimate business interests do not require that it should be compensated, through adjustments to the cost allocation factors, for declining demand for the fixed line services or for loss of market share. The ACCC considers that Telstra has been appropriately compensated for these business risks through the risk premium included in the commercial rate of return provided by the WACC.
Paragraph 152BCA(1)(c) – interests of all persons who have rights to use the declared service	The cost allocation factors allocate costs to the declared fixed line services used by access seekers and have been determined to reflect the relative usage of the assets in supplying each of the declared fixed line services. The ACCC considers that the cost allocation factors used to derive wholesale access prices will enable the access provider to recover its efficient costs of supplying access to the declared fixed line services. They will also prevent the access provider from shifting additional costs to the declared fixed line services. Access prices that reflect efficient costs will support efficient

[10] Inquiry to make final access determinations for the declared fixed line services Final Report July 2011, Chapter 16.3.

Section 152BCA(1) matter	ACCC conclusion
	investments by access seekers. In addition, such prices will promote efficient investment decisions by the access provider in the network assets used to supply the declared fixed line services. Efficient investment in network assets will, in turn, support the provision of services that meet the needs of access seekers in relation to quality and availability.
152BCA(1)(d) – direct cost of providing access to the declared service	The ACCC has identified and included the direct costs of providing access to the declared fixed line services in the FLSM. The cost allocation factors used in the FLSM allocate an appropriate share of directly attributable costs to the relevant service. The share of attributable costs allocated to a particular service is based on usage of the assets used to provide the service. For costs that cannot be attributed to particular services, such as corporate overheads, the cost allocation factors allocate a share of these indirect costs to services based on allocation rules broadly related to each service's usage of network assets.
Paragraph 152BCA(1)(e) – the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else	The cost allocation factors used in the FLSM do not allocate to the declared services costs that are borne by someone else. The cost allocation methodology ensures that costs are not allocated more than once.
Paragraph 152BCA(1)(f) – the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility	The ACCC considers the cost allocation factors used in the FLSM will contribute to promoting the safe and reliable operation of the declared fixed line services and the access provider's CAN and Core networks. The cost allocation factors used in the FLSM ensure that the revenue requirement for each of the declared fixed line services will cover the efficient costs of providing that service. These costs included the costs of maintenance and asset replacements that are needed to meet the operational and technical requirements necessary for the safe and reliable operation of the declared fixed services and the access provider's CAN and Core networks. By ensuring that the access provider can meet the costs associated with meeting these operational and technical requirements, the cost allocation factors will provide an incentive for the access provider to undertake the necessary expenditures.
Paragraph 152BCA(1)(g) – the economically efficient operation of a carriage	The ACCC considers that the cost allocation factors used in the FLSM will encourage the efficient operation of carriage services provided on the PSTN. This incentive is created by

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Section 152BCA(1) matter	ACCC conclusion
service, a telecommunications network or a facility	ensuring that the cost allocation factors only allocate efficient costs to the declared fixed line services. The ACCC considers that its cost allocation methodology will provide the access provider with an incentive to operate the network efficiently, to provide the declared fixed line services efficiently, and undertake efficient investments in the assets used to provide those services.

When considering the role that the FLSM model should play in this inquiry, it is useful to consider how the FLSM would be used in the current inquiry if Telstra had not submitted the CAF. iiNet submits that in this scenario, the appropriate process to adopt would be to work through the following steps:

1. Determine if Telstra's forecasts are fit for purpose. If yes move to step 2, if no take steps to ensure that Telstra provides forecasts that are fit for purpose.

2. Update the inputs to the FSLM on the basis of Telstra's forecasts and obtain the new outputs from the FLSM (i.e. no adjustments are made to the FSLM methodology - for ease of expression this will be referred to as the **Current FLSM Rolled Forward**).

3. Determine whether there is a need to adjust or review the FSLM outputs or whether they can be applied 'as is'.

It is important to note that while the ACCC is bound to give appropriate weight to the outputs of the FLSM, the ACCC is not necessarily bound to adopt those outputs as final prices and the ACCC can still consider adjusting or fine tuning the FLSM outputs if this will deliver a better outcome. That said, the analysis undertaken by the ACCC in 2011 suggests that there would be no need for the ACCC to adjust or review the outputs of the Current FSLM Rolled Forward.

It needs to be acknowledged that Telstra argued in 2011 that the ACCC's approach to cost allocation did not allow Telstra to recover its costs but the ACCC rejected this contention (i.e. we have been here before).[11] In this regard, it is worth noting that Telstra's current fixed line EBITDA margins are at 60% and this has not changed since 2011.[12] iiNet submits that if the ACCC's cost allocation factors were leading to Telstra not being able to recover its costs, a constant margin would be unlikely.

iiNet also notes that Telstra has argued that the ACCC's current approach to cost allocation is flawed because it does not allocate costs on the basis of 'relative use' as required by fixed principle 6.14(a).[13] Fixed principle 6.14 provides that:

(a) The allocation of the costs of operating the PSTN should reflect the relative usage of the network by various services.

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[11] Inquiry to make final access determinations for the declared fixed line services Final Report July 2011, at p.98.
[12] Telstra Annual Report 2014.
[13] ACCC workshop, August 2014.

(b) Direct costs should be attributed to the service to which they relate. The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.

(c) No cost should be allocated more than once to any service.

(d) The determination of cost allocation factors should reflect the principles in 6.14 (a) – (c) above except where reliable information is not available to support the application of the principles.

iiNet believes that Telstra's arguments may have some merit if fixed principle 6.14(a) were to be redrafted as follows:

> *The allocation of the costs of operating the PSTN should reflect the relative usage of the network by ~~various~~ all services that use the network*

However, on the current drafting of fixed principle 6.14(a), the ACCC's current approach is clearly consistent with fixed principle 6.14(a) because the ACCC's current approach does allocate costs as between the individual *Declared Services* on the basis of each Declared Service's relative use of the network as compared to each other relevant Declared Service. As stated by the ACCC:[14]

> *[The current cost allocation factors] effectively hold fairly constant the share of costs allocated to each unit of service (that is, by SIO for ULLS and WLR, and by minute of traffic for LCS and PSTN OTA). Changes in demand will therefore be reflected in the total costs allocated to the service. That is, if demand increases, the total share of costs allocated to the service will increase to reflect its increased usage of the assets used to provide it.*

This means that for example:

- if there is an increase in ULLS usage, there will be a higher proportion of costs allocated to the ULLS service relative to other services; and
- if the usage of ULLS is higher than WLR, the percentage of common costs allocated to ULLS will be higher than the percentage of common costs allocated to WLR.

Given that the purpose of the FLSM is to set prices for the Declared Services only (i.e. the FLSM does not set a price for any other services), it is not surprising 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. In light of the above, iiNet submits that fixed principle 6.14(a) does not require the ACCC to depart from its current approach. Indeed it would be strange if the ACCC had developed a cost model that is inconsistent with its own fixed principles.

iiNet submits that it can be concluded, on the basis of ACCC's own analysis of the FLSM in 2011, that the Current FLSM Rolled Forward would deliver outputs that appropriately

[14] Inquiry to make final access determinations for the declared fixed line services Final Report July 2011, at p.98.

balance the different elements of the statutory test that the ACCC must apply. In light of this, iiNet submits that it would be erroneous for the ACCC to consider changes to the FLSM methodology without comparing the different outputs that would result and ascertaining which would best promote the LTIE (i.e. it is not enough for the ACCC to consider issues in isolation, it must consider the overall outcome). iiNet submits that doing this is particularly important in this inquiry because, as discussed in section 5 above, when resultant outputs are considered, Telstra's proposed changes to cost allocation do not satisfy a basic sanity check.

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8. IT IS APPROPRIATE FOR TELSTRA TO CONTINUE TO BEAR THE IMPACTS OF DECLINING DEMAND

The approach to declining demand that the ACCC took when it developed the FLSM was that neither the decline in total demand for fixed line services nor Telstra's loss of market share should be reflected in the FLSM (for ease of expression this will be referred to as **the Demand Allocation Principle**). At the outset it should be acknowledged that the ACCC's decision to adopt the Demand Allocation Principle was a decision based on principle. It was not a decision based on pragmatism due to a lack of available information from Telstra. In this regard iiNet notes that the ACCC has stated that adoption of the cost allocation factors in the FLSM more generally was due to a lack of detailed information from Telstra.[15] However, the unavailability of information about the use of Telstra's assets is not relevant to the issue of how falling demand should be treated. How falling demand should be treated is a distinct and free standing issue of methodological principle. This is demonstrated by the fact that it was possible for the ACCC back in 2011 to make its current cost allocation factors result in access seekers bearing the impacts of falling demand but the ACCC chose, rightly in iiNet's view, not to do so. Therefore, the fact that Telstra has now chosen to provide more detailed information about the use of its assets (by means of its proposed CAF) is irrelevant to this issue of methodological principle, and it cannot justify the ACCC departing from the Demand Allocation Principle.

iiNet notes that the ACCC states the following in the Discussion Paper:[16]

> *The ACCC considers that the approach to cost allocation adopted in the 2011 FAD, where Telstra bears the impact of declining demand (through the maintenance of cost unit costs), represents one end of a spectrum for how declining demand can be shared. Further, it considers that Telstra's proposed framework, where customers bear the impact of declining demand (by allowing recovery of costs from a smaller demand base), represents the other end of that spectrum. The ACCC considers that if Telstra and access seekers are to both incur a share of the impacts of declining demand, then this would need to be reflected in modifications to the ACCC's current approach to cost allocation, or to Telstra's proposed cost allocation framework.*

This statement proposes three possible outcomes:

- Telstra bears the impacts of declining demand;
- access seekers bear the impacts of declining demand; or
- the impacts of declining demand are shared between Telstra and access seekers.

iiNet submits that when considering which outcome is most appropriate, it is important to:

- identify the causes of declining demand; and

[15] Industry workshop August 2014.
[16] Discussion Paper, at p.48.

- keep in mind the fundamental distinction between:
    - allowing Telstra to recover the efficient cost of providing the Declared Services; and
    - guaranteeing that Telstra will maintain its PSTN revenues and, by doing so, effectively insulating Telstra from the effects of competition and the risks of doing business.

As regards the causes of declining demand, iiNet notes that the ACCC has identified three different causes of declining demand as follows:[17]

- competition from access seekers;
- migration to the NBN; and
- substitution away from fixed line services towards mobile and other technologies,

(for ease of expression referred to collectively as the **Causes of Declining Demand**).

iiNet submits that declining demand for Telstra's services due to the Causes of Declining Demand either individually or collectively does not justify the ACCC departing from the Demand Allocation Principle. Furthermore, it is necessary to consider the not insignificant problem of how to allocate a particular fall in demand (or proportion thereof) to a particular Cause of Declining Demand (i.e. even if it were to be concluded that a particular Cause of Declining Demand should, as a matter of principle, be borne by access seekers, isolating the extent to which overall declining demand has been caused by this one cause may not actually be possible in practice).

Each of the Causes of Declining Demand is considered below.

8.1 Competition from access seekers

The effect of making access seekers bear the impacts from declining demand caused by access seekers is neatly summarised in the following passage in the Discussion Paper (emphasis added):[18]

> *Another important implication of Telstra's proposed approach is that declining demand for one service will have impacts on prices for other services. If demand for one service (declared or non-declared) falls, higher per unit costs will be spread across all services that use the same assets. Therefore,* ***if demand for Telstra's retail voice services falls while ULLS and WLR demand grows, the ULLS and WLR prices would increase (assuming nothing else changed).*** *This contrasts to the current approach, in which changes in demand for a particular declared service affect the cost allocation factors for that service only.*

[17] Discussion Paper, at p.49.
[18] Discussion Paper at p.48.

Increasing the price of WLR and ULLS to offset the effects of access seeker competition will not promote the LTIE because it will effectively insulate Telstra from the effects of access seeker competition and punish access seekers, through higher access prices, for winning market share from Telstra by being more efficient than Telstra. Such an approach will not present any efficiency incentives for Telstra (i.e. Telstra could provide its retail services in an inefficient manner safe in the knowledge that any resultant loss of market share will be compensated through higher access prices and, given that Telstra itself is not subject to those access prices, higher access prices would reduce the ability of access seekers to compete with Telstra on the basis of efficiency, thereby maintaining an inefficient level of infrastructure usage). Such an approach is the antithesis of an approach that seeks to promote the LTIE. Therefore, reduced demand for Telstra's retail services due to competition by access seekers does not justify a departure from the Demand Allocation Principle.

8.2 Migration to the NBN

The Definitive Agreements between Telstra and NBN Co mean that Telstra will be compensated by NBN Co for services that are migrated to the NBN. Therefore, increasing the price of the Declared Services in order to reflect reduced demand caused by migration to the NBN will lead to Telstra being compensated twice. This issue has already been considered by the ACCC. In dealing with the issue of cost allocation for falling total demand during the 2011 FAD public inquiry, the ACCC came to the following conclusion (emphasis added, footnotes omitted):[19]

> *The ACCC has noted reported comments by Telstra's chief executive, in a recent media interview, that* the proposed deal between Telstra and NBN Co will compensate Telstra for loss of market share*.* ***The ACCC considers that Telstra would be compensated twice if any compensation for loss of market share were to be allowed in estimating prices for the declared fixed line services****. Telstra's chief executive is also reported as stating, in the same interview, that: '****There ain't another telco in the world that would be compensated for decline in margin and market share in their PSTN [traditional fixed line] business.****'*

iiNet believes that the ACCC's conclusion on this issue in 2011, was, and remains, sound.

iiNet notes that the ACCC has released a position statement on how it proposes to account for the payments received by Telstra from NBN Co.[20] iiNet notes that the ACCC intends to take a 'regulatory values' approach to the NBN payments. There are three distinct type of NBN payments as follows:

[19] Inquiry to make final access determinations for the declared fixed line services Final Report July 2011 Public version, at p.100.

[20] Final access determinations for fixed line services – primary price terms – Position Statement on the treatment of the Telstra-NBN Co arrangements for regulated pricing.

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- Payments for assets that are sold to NBN Co – The ACCC proposes to treat these as asset disposals and to remove the regulatory values of those assets from the RAB.

- Payments for assets that are leased to NBN Co - The ACCC proposes to account for this in the cost allocation framework of the FLSM.

- Payments for the migration of customers to the NBN (**Migration Payments**) - The ACCC considers that as a consequence of the migration of customers to the NBN, certain fixed line assets will be decommissioned or utilised to a lesser extent. The ACCC proposes to remove the regulatory values of decommissioned assets and *an appropriate share of assets utilised to a lesser extent from the cost base*.

iiNet submits that a pragmatic way to allocate an appropriate 'share of assets' in respect of the Migration Payments, is to adjust the regulated cost base to the extent necessary to offset the decline in demand caused by the NBN. Proceeding in this way will ensure that Telstra is not compensated by access seekers for a fall in demand caused by migration to the NBN in circumstances where Telstra is already receiving compensation from NBN Co for this.

8.3 Substitution away from fixed line services towards mobile and other technologies

The following are relevant considerations that the ACCC needs to consider as regards falling demand caused by mobile substitution:

- Falling demand for fixed line services does not just affect Telstra's investments. It also affects access seekers' investments.

- Telstra owns and operates the biggest mobile network in Australia.

Each of these points will be considered in turn.

Falling demand for fixed line services does not just affect Telstra's investments

The fact that access seekers' investments can also be affected by falling demand is usefully illustrated by the following simplified example:

> *An access seeker installs equipment at an exchange building so that it can use the ULLS to provide services in the retail market for fixed services. The cost of the equipment is $100. Competitive pressures in the retail market mean that the access seeker cannot charge more than $10 per service. The access seeker initially provides 10 services at $10 each. However, if falling demand means that the access seeker is only able to recover $90 from its retail services (assuming it is as efficient as it can be), the access seeker will need to find another way of recovering the cost of its investment.*

Falling demand is one of the fundamental risks of doing business in a competitive market. Allowing the price for Declared Services to be increased due to a fall in demand for fixed line services would insulate Telstra from this risk and thereby put Telstra in a more

privileged position than its competitors. iiNet submits that Telstra's legitimate business interests do not justify Telstra being insulated from the normal risks of doing business.

Telstra owns and operates the biggest mobile network in Australia

When considering Telstra's legitimate business interests, the ACCC needs to consider the fact that the corollary of a reduction in demand for fixed line services due to mobile substitution is an increase in demand for mobile services. This corollary together with the fact that Telstra is the owner and operator of the biggest mobile network in Australia, means that Telstra is:

- one of the causes of reduced demand for fixed line services; and
- one of the beneficiaries of increased demand for mobile services.

In light of this, iiNet submits that a fall in demand caused by mobile substitution does not justify a departure from the Demand Allocation Principle.

9. THERE IS NO JUSTIFICATION FOR DETERMINING A RANGE OF PRICES FOR THE DECLARED FIXED LINE SERVICES OUTSIDE THE FLSM

With the exception of WDSL, the existing process for setting prices for the other Declared Services can be described, at the highest level, as a two step process as follows:

- Step 1 – the input data (for example demand data) to be plugged in to the FLSM is determined.
- Step 2 - the FLSM determines the prices for each service (as discussed in section 7 above, the design of the FLSM was intended to ensure that the FLSM would deliver outputs that could be applied 'as is' without the need for further consideration).

The ACCC states that in the course of discussions between the ACCC and Telstra before the start of the FAD inquiry, Telstra suggested that a new approach to setting prices for each Declared Service could be adopted. Under this new approach, which the ACCC notes has been adopted or reflected in other regulatory contexts:

- prices for each individual Declared Service would be set so that revenue earned from those prices is between the avoidable cost and stand alone cost of supplying that Declared Service; and
- prices for all the Declared Services would be set so that Telstra will recover the total revenue requirement for the Declared Services.

It appears to iiNet that this new approach would require three steps as follows:

- Step 1 – the input data (for example expenditure and demand data) to be plugged in to the cost model is determined.
- Step 2 – the cost model (this could be the FLSM amended as required) determines the total revenue requirement and the avoidable cost and stand alone cost for each individual Declared Service.
- Step 3 – the ACCC determines prices for each individual Declared Service within the range of avoidable cost and standalone cost so that the total revenue requirement is satisfied.

iiNet notes that the Discussion Paper identifies the following issues that would need to be addressed if this new approach is adopted:

- Estimates of avoidable cost and stand alone cost for each Declared Service would need to be developed.
- The new approach introduces regulatory discretion into the setting of prices for Declared Services. A clear framework for determining prices outside of the FLSM would be needed to ensure that prices are not determined in an arbitrary manner.
- Different access seekers are likely to favour different pricing combinations depending on how they use Telstra's infrastructure.

iiNet believes that each of these issues is likely to be subject to significant disputation and there will be a need for careful and detailed consideration and consultation. iiNet further notes that this new approach appears to only have been raised at a concept level during preliminary discussions between Telstra and the ACCC and it is not currently supported by any formal submissions or any detailed proposals as to how the points above would be addressed. Given the significant issues that must be determined during this FAD process even if the ACCC maintains its existing approach (i.e. ensuring that Telstra's forecasts are fit for purpose and dealing with the effects of the NBN), iiNet questions the desirability of contemplating significant additional changes of this nature.

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10. THERE IS A NEED FOR CLOSE SCRUTINY OF TELSTRA'S FORECASTS

The Building Block Record Keeping Rule (**BBM RKR**) requires Telstra to provide information to the ACCC including forecasts relating to demand, capital expenditure and operational expenditure in respect of the next regulatory period. On 25 November 2013 Telstra provided its response to the BBM RKR. Telstra provided further information on 10 February 2014 in response to requests from the ACCC for clarification in respect of the information Telstra had provided on 25 November 2013. For ease of expression, Telstra's responses of 25 November 2013 and 10 February 2014 will be referred to collectively as (**Telstra's RKR Response**).

As regards the demand forecasts in Telstra's RKR Response, it is clear that these forecasts are not fit for purpose because they are based on out of date assumptions about the NBN rollout.[21] As regards the expenditure forecasts included in Telstra's RKR Response, iiNet agrees with the view in the Discussion Paper that Telstra's approach for taking into account the impact of the NBN rollout in Telstra's expenditure forecasts appears to differ from the approach taken in Telstra's demand forecasts.[22] This is a significant cause for concern and, of itself, should lead to the expenditure forecasts in Telstra's RKR Response being rejected.

More broadly, iiNet is concerned that it has not been established that the forecast expenditure in Telstra's RKR Response represents prudent and efficient costs. In this regard the fixed principles require the following matters to be considered:

- the access provider's level of expenditure in the previous regulatory period;
- reasons for proposed changes to expenditure from one regulatory period to the next regulatory period;
- whether the access provider's asset management and planning framework reflects best practice;
- any relevant regulatory obligations, or changes to such obligations, applicable to providing the relevant declared fixed line services;
- Where Telstra is exposed to competition, their access prices invariably reduce, indicating inefficient over-recovery prior to competition; and
- any other matters relevant to whether forecast expenditures reflect prudent and efficient costs.

Telstra's approach appears to be that the ACCC should accept that Telstra's expenditure forecasts represent prudent and efficient expenditure because all Telstra investments are subject to internal competition and the discipline that this imposes leads to Telstra's

[21] Discussion Paper, at P.10.
[22] Discussion Paper, at. pp.16 and 25.

investments in its fixed line network being prudent and efficient.[23] iiNet is not convinced by this argument because the very acceptance of this argument by the ACCC is likely to lead to it not being valid. In other words, if the ACCC accepts this argument then Telstra will have the security of knowing that any investment it makes in the assets that are used to provide the Declared Services will be assumed to be efficient and prudent and Telstra will be guaranteed a return of its investments in those assets at the WACC rate even if those investments are neither efficient nor prudent. iiNet submits that in order to satisfy the requirements of the fixed principles, it is necessary for Telstra's expenditure forecasts to be the subject of proper independent scrutiny. This could include a benchmarking exercise where appropriate.

iiNet notes that Telstra has moved on from its RKR Response and has developed a new forecasting model. iiNet notes that stakeholders have not yet had a chance to consider this new model and the assumptions on which it is based. Clearly, there is a need for the inquiry process to allow a reasonable opportunity for stakeholders to consider Telstra's new model.

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[23] Telstra Corporation Limited Final Access Determinations (FADs) Inquiry – response to information request under the BBM RKR, 25 November 2013, Public Version, at p.6.

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11. CONCLUSION

This submission started off by identifying the central question at the heart of this inquiry as being:

> *What should the access prices for the Declared Services be during the next regulatory period?*

iiNet submits that when the rationality of each of the three possible broad outcomes is considered under circumstances where:

- Telstra has no incentive to invest in the legacy network; and
- Telstra is being compensated by NBN Co for falling demand,

it quickly becomes apparent that the central question at the heart of this inquiry becomes:

> *By how much should access prices for the Declared Services be reduced?*

iiNet believes that when considering this question the ACCC needs to give appropriate weight to the outputs that result when the current FLSM is rolled forward.

iiNet Limited
5 November 2014