Australian Government

Department of Communications

Drew Clarke

Secretary

Mr Rod Sims
Chairman
Australian Competition and Consumer Commission
By email: rod.sims@accc.gov.au

Dear ~~Mr Sims~~ Rod

ACCC further draft decision - inquiry into primary prices for fixed-line services

I am writing to provide the Australian Competition and Consumer Commission (ACCC) with the Department of Communications' submission on the above matter.

The submission sets out the Department's concerns that the ACCC's proposed approach to dealing with assets that will become redundant or are under-utilised as a result of NBN migration does not allow appropriate recovery of the costs incurred in supplying regulated fixed line services.

The submission also sets out the Department's concerns that the ACCC has not given adequate consideration to the importance of price stability in the structural reform of the telecommunications industry and ensuring a smooth migration of services to the National Broadband Network.

The Department encourages the ACCC to revisit these matters in making its final decision.

If the ACCC would like to discuss the Department's submission further, please contact Philip Mason, Assistant Secretary, Market Structure Branch on (02) 6271 1579.

Yours sincerely

Drew Clarke
17 July 2015

cc. Ms Jane Goldwater, Director, Access Pricing and Financial Analysis

Australian Government

Department of Communications

Final access determinations for fixed-line services—primary price terms

Department of Communications submission on the Australian Competition and Consumer Commission's further draft decision

17 July 2015

Key Points

- The ACCC's treatment of redundant assets and adjustments to cost allocation to deal with asset under-utilisation and loss of economies of scale appear to prevent Telstra recovering relevant costs, and this is inconsistent with fixed principles and the objects of Part XIC.
- Despite the loss of economies of scale due to migration to the NBN, network costs are still caused by, and attributable to, the users of the network and should be recovered from them.
- The levelisation of prices across the regulatory period is appropriate to prevent price shock but levelisation needs to allow the recovery of appropriate costs.
- The ACCC's suggestion that Telstra should have sought to recover costs through the Definitive Agreements confirms there is an under-recovery of costs but it would not have been appropriate to recover them through that mechanism and it is not a mechanism that is available anyway.
- The proposed price reduction is inimical to price stability and a smooth pricing transition path to the NBN, potentially disrupting migration to the NBN and the structural reform of the industry.
- The ACCC should revisit its proposed approach to ensure consistency with the fixed principles, Telstra can recover appropriate costs, price stability is adequately considered, and the Government's wider industry reform agenda is supported.

Introduction

The Department of Communications welcomes the opportunity to comment on the Australian Competition and Consumer Commission's (ACCC) further draft decision on its fixed line services final access determination (FLS FAD) inquiry, published on 29 June 2015.

The Department's interest in this inquiry is to ensure that telecommunications industry participants have long term certainty over investments and also that the long term structural reform of the industry is realised, through smooth migration of customers to the National Broadband Network (NBN).

The ACCC is in the process of making FADs for the seven declared FLSs – the unconditioned local loop service, the line sharing service, fixed originating and terminating access services, the wholesale line rental service, the local carriage service and the wholesale asymmetric digital subscriber line service. As part of this process the ACCC has commenced an inquiry into setting final primary prices for the seven declared services.[1]

In October 2014, the Department made a submission to the ACCC's initial consultation on primary price terms, setting out its position on how the ACCC should treat payments to Telstra by NBN Co under the Definitive Agreements (DAs). In summary, the Department's submission argued that:

- the FLS FAD outcome should support the significant reform of the telecommunications industry that is underway;
- payments by NBN Co to Telstra are generally irrelevant to the ACCC's determination of FLS access prices; and
- price stability, at least in real terms, in the period to the migration to the NBN is important, particularly in support of wider structural reform of the industry.[2]

The Department's submission supported an earlier letter sent by the Minister for Communications and the Minister for Finance to the ACCC Chair relating to the current FLS FAD inquiry.[3]

In March 2015, the ACCC released a draft decision (the March 2015 draft decision) which, amongst other things, outlined how the ACCC proposes to deal with Telstra's assets that will progressively be made redundant due to the migration of fixed-line services to the NBN. The ACCC proposes to treat a proportion of the regulatory value of assets made redundant by NBN migration as an asset disposal in the roll-forward mechanism for the regulatory asset base (RAB). The March 2015 draft decision proposed a uniform price decrease of 0.7 per cent, subject to a number of additional information to be submitted by Telstra and the ACCC forming a view on how to deal with assets that will become under-utilised as a result of NBN migration.

In June 2015, the ACCC released a further draft decision (the further draft decision) which, amongst other things, outlined how the ACCC proposes to deal with Telstra's assets that will be made under-utilised due to the migration of fixed-line services to the NBN through adjustments to the cost allocation framework. This decision reaffirmed the March 2015 draft decision's proposal to treat a proportion of the regulatory value of assets that will be made redundant due to NBN migration as an asset disposal. The adjustments to the cost allocation factors, in part, lead to a uniform price decrease of 9.6 per cent for all regulated fixed-line services.

The Department is concerned that the approach proposed by the ACCC in making adjustments to the RAB and cost allocation factors may prevent appropriate cost recovery. If Telstra is unable to recover its costs, this would raise wider issues as to whether the draft decision is consistent with the long-term interest of end-users test in Part XIC of the *Competition and Consumer Act 2010* and more generally, would be inconsistent with investors being able to receive an appropriate return on their investments.

The Department is also concerned that the ACCC's further draft decision does not adequately take the broader policy context into consideration, notably the importance of price stability in the

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[1] ACCC (2014a) **Public Inquiry into final access determinations for fixed line services—primary price terms – Discussion paper**.
[2] Department of Communications (2014) **Submission to the Australian Competition and Consumer Commission.**
[3] The Hon Malcolm Turnbull MP and Senator the Hon Mathias Cormann (2014) **NBN Co Payments to Telstra and ACCC Fixed Line Access Determinations**.

transition to the NBN and potential disruption of migration of customers from Telstra's network to the NBN.

The Department is particularly concerned that the draft charges are not consistent with the fixed principles made by the ACCC in 2011 in its final access determination on fixed line services (the 2011 FLS FAD). As a result, the draft charges may not allow Telstra to recover its costs of investment. That Telstra is not being permitted to recover its costs is inherent in the ACCC's statements that it considers Telstra should have recovered costs for under-utilisation of its assets through its negotiations of the DAs. While the Department agrees there is benefit in levelling prices for the regulatory period concerned, we do not agree that the proposed adjustment to the cost allocations is necessary to achieve this.

Telstra's ability to recover its costs

In the further draft decision, the ACCC proposes to adjust the cost allocation factors to reflect that certain assets will progressively become under-utilised as a result of NBN migration, which largely drives the proposed uniform price decrease of 9.6 per cent for all regulated fixed line services.[4] In our view, these adjustments will prevent Telstra recovering its costs in a way that is inconsistent with the fixed principles, made by the ACCC in its 2011 FLS FAD.

The purpose of the fixed principles in the FLS FAD, and of Part XIC more broadly, is to give industry participants certainty over investments and the ability to recover costs associated with them. Amongst other things, the fixed principles in the FLS FAD were designed to assist industry participants in their business and investment planning during the transition to the NBN.

The fixed principles include a mechanism to be used to roll forward the RAB at the start of each year. This formula allows the RAB to be adjusted for the depreciation of assets, new capital expenditure, and any asset disposals, the last of which accounts for the transfer of assets from Telstra to NBN Co. The fixed principles also require that direct costs should be attributed to the services to which they relate and the allocation of the costs of operating the public switched telephone network (PSTN) should reflect the relative usage of the network by various services.

The Definitive Agreements, including payments from NBN Co to Telstra, were negotiated on the basis that these principles would be fixed and, as the further draft decision points out, Telstra is not receiving compensation for the under-utilisation of its assets during the migration to the NBN. Further, Telstra and other industry participants have made investment decisions on the basis that the RAB will be rolled forward in accordance with the fixed principles.

As set out in the Department's previous submission, it considers that assets that are transferred from Telstra to NBN Co should be removed from the RAB through disposals as part of the roll-forward mechanism and it would be inappropriate for fixed line service prices to reflect the costs of these transferred assets. However, the cost of assets remaining in the asset base need to be recovered in an appropriate way from users of the fixed network.

We do not consider that it is appropriate to adjust the cost allocation factors in a manner that results in Telstra being unable to recover its costs in supplying regulated fixed line services. In doing so, the ACCC appears to be reducing revenue requirements in such a way as to prevent significant relevant costs being recovered. The ACCC could be seen as seeking, in effect, to

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[4] The Department recognises that a reduction in the Weighted Average Cost of Capital (WACC) since the 2011 FLS FAD is putting significant downward pressure on charges. However, this was evident in the March draft decision and the proposed reduction of 0.7 per cent. Given other elements of the further draft decision put upward pressure on the charges, it is clear that the key driver of the 9.6 per cent increase is the adjustment to the cost allocations.

optimise the RAB in a way that is contrary to both the fixed principles and the fundamental policy underpinning them. It is fundamental to the building block approach the ACCC has adopted for the regulatory costing of fixed line services that industry should have certainty regarding the ACCC's regulatory approach. The value of the RAB is to be determined in accordance with the fixed principles. Equally, the assessment of operating expenditure is to be determined in accordance with the relevant fixed principles, and the ACCC has generally accepted Telstra's expenditure forecasts as efficient and prudent. That is, the cost pool Telstra should be able to recover is generally established. Notwithstanding this, by adjusting the cost allocation factors, the ACCC is effectively preventing the full recovery of these costs. If Telstra appreciated that the ACCC would seek to change the cost allocation approach in this way, it would likely have taken this into account in making business and investment decisions.

The ACCC's essential rationale for its approach to under-utilisation is set out at the bottom of page 76 of the further draft decision. Quite clearly, services will migrate to the NBN, assets will be under-utilised as a result of this and there will be a loss of economies of scale. While migration may be the cause of this issue, and not the demand of access seekers, access seekers (along with Telstra) nevertheless are requiring the assets concerned to be kept in service to provide the services they need. Users of the fixed line network are therefore causing the cost of the assets that remain in service and there is a causal relationship between their demand and the costs of the assets concerned.

The Department also considers the approach to adjusting cost allocation that the ACCC has adopted raises three methodological issues. First, the ACCC is scaling down cost allocation factors when the ACCC has generally accepted Telstra's full cost allocation framework (p.81). Second, the ACCC compares unit costs where 'NBN-induced under-utilisation did not occur' (the counter-factual) with the situation where there is migration to the NBN (the status quo) (pp.73-74). It is not clear to the Department why the counter-factual should be one where there is no 'NBN-induced under-utilisation'. It has been the policy of successive governments since at least 2009 that a new national broadband network should be built. It would therefore seem that any counter-factual should recognise the impact of a new national broadband network. Third, and more mechanical, in Step 1 of its methodology, the ACCC holds operating expenditure constant in real terms over the regulatory period. This is described as a conservative approach as it does not accommodate potential efficiency gains or costs savings (p.76). However, even if the overall adjustment to cost allocation being made here was considered valid, this would seem questionable. Arguably, Telstra would likely face higher opex in a world where it did not face NBN-induced under-utilisation. It also inconsistent with the ACCC's acceptance of Telstra's forecast model to determine pre-NBN forecasts for capital expenditure and demand. To the extent these methodological issues affect the scaling down factors, they affect Telstra's ability to recover its costs.

The Department's key focus has been on the adjustments to the cost allocation framework because of its significant impact. However, the Department is also concerned that the ACCC's proposal to treat a proportion of the regulatory value of assets made redundant by NBN migration as an asset disposal at a realised price equivalent to their RAB value in the roll-forward mechanism for the RAB is not consistent with the fixed principles. As noted above, we consider that assets that are transferred from Telstra to NBN should be removed from the RAB. However, removing a proportion of the regulatory value of assets that are made redundant but remain with Telstra does not enable Telstra to recover its costs for these assets. As Telstra is not receiving any consideration for the de-commissioning of these assets, they should not be removed from the RAB through the disposal mechanism, rather these assets should be depreciated in an accelerated manner, in order to allow Telstra to recover its costs.

To the extent costs are not otherwise recovered, Telstra needs the opportunity to recover them. These costs should be allocated according to access seekers' usage relative to Telstra's, however, this does not happen because of the changes made to the cost allocation factors and the RAB. Instead, these adjustments have the effect of making Telstra bear a significantly greater proportion of the residual costs; it does not allow the full recovery of the residual costs from all users and therefore there is not full cost recovery. Given that Telstra would have difficulty increasing its retail prices to recover the costs due to competition from competitors with access to lower cost access charges, Telstra will need to absorb the cost. The question of whether Telstra should have recovered these costs through the DA negotiations is not relevant to the ACCC's current inquiry. The costs remain and need to be recovered. For the ACCC to say that the costs should have been recovered through the DA process indicates that the costs are not recovered.

It should also be noted that if the ACCC removes assets from the RAB that Telstra needs to continue to use to provide fixed line services, via the asset disposal mechanism, then this would also be inconsistent with the fixed principles and lead to under-recovery of costs for Telstra. This could include, for example, local switching assets and certain fibre-to-the-premises assets.

The ACCC has stated in its media release on the further draft decision that 'eventually these prices would reach absurd levels for the unlucky last copper customers' in the absence of its proposed approach. The Department agrees that this concern should and can be dealt with through a one-off uniform change in charges, as proposed by the ACCC. However, it should not be implemented in a way that prevents costs being appropriately recovered. The critical issue is not whether the charges should be levelled, but whether the level at which they are held constant will allow an appropriate recovery of costs.

Price stability

As set out in earlier submissions to the FLS FAD inquiry by the Minister for Communications and the Minister for Finance[5] and the Department[6], the Government considers that the FLS FAD outcome should give the highest possible priority to pricing stability. This includes the price of fixed line services relative to the price of NBN services and the smooth migration of customers from legacy networks to the NBN. By not providing for such price stability, the Department is concerned that the further draft decision does not give adequate consideration to the broader policy context and structural reform of the telecommunications industry, which is designed to substantially improve the quality (speed, reliability and ubiquity) of Australia's broadband network, and enhance the level of competition in the sector to deliver benefits to telecommunications customers. To date, the ACCC and the wider industry have been strong supporters of this structural reform, particularly in regard to the structural separation of Telstra but also for the building of, and smooth migration to, the new high speed broadband network.

In making its further draft decision, the ACCC does not appear to have given adequate consideration to price stability and the likely impact of such a significant price decrease would have on migration to the NBN. Instead, the further draft decision appears to mirror the approach taken in New Zealand, where the pricing differential between copper-based services and fibre-based services raised questions about incentives to migrate to the fibre network.

The Department is concerned that the proposed price decrease for fixed line services will discourage migration throughout the migration window and could lead to a significant number of

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[5] The Hon Malcolm Turnbull MP and Senator the Hon Mathias Cormann (2014) **NBN Co Payments to Telstra and ACCC Fixed Line Access Determinations**.

[6] Department of Communications (2014) **Submission to the Australian Competition and Consumer Commission.**

customers remaining on the old network in the lead-up to the disconnection date.

If retail providers pass through the proposed price decrease to customers, this could lead to significant price shock for customers on migrating to the NBN. A number of retail providers currently offer NBN-based services that are comparable, in terms of price and inclusions, to similar copper-based services. By our analysis, if current retail pricing on the NBN is maintained but current retail prices fall in line with the proposed reduction in charges, customers will be forced to pay close to 10 per cent more for telephone and internet services after migrating to the NBN. This could delay migration and lead consumers to potentially false expectations about the prices they should pay for broadband going forward. If retail providers do not pass through the proposed price decrease, this could also delay migration as retail providers will have an incentive to delay the migration of their customers to the NBN in order to obtain the higher margins available for services supplied over the legacy network. This is separate from the issue as to whether this benefit comes to them as a result of an under-recovery of Telstra costs.

Higher prices are also inimical to pricing stability. As noted above, the ACCC has expressed concerns about prices rising to absurdly high levels in the absence of its proposed cost allocation adjustments. This is an issue that can be managed through the levelisation of prices but those levels need to allow for cost recovery. Moreover, given the impact of inflation, there would need to be a significant increase in nominal prices for there to be an increase in real prices. As the Department understands it, increases of this quantum are unlikely, even in the absence of the adjustments to cost allocation proposed.

As set out in the Department's previous submission, the most beneficial form of price stability would be a form which provided stability in the relative prices of different fixed line services. This will encourage retail providers and customers to migrate legacy services to the NBN in a timely manner and improve NBN Co's ability to achieve a rate of return on the rollout.

For the reasons set out above, the Department urges the ACCC to revisit its proposed approach to dealing with assets that will progressively be made redundant due to the NBN rollout in order to ensure that the approaches are consistent with the fixed principles, that prices for fixed line services reflect the actual cost to Telstra in supplying the services, reflect the general principle that investors should be able to recover their costs, and that price stability is adequately considered. The Department considers that taking these matters into consideration will encourage economic efficiency and therefore promote the long-term interests of end-users.