

**Optus Submission to
Australian Competition and Consumer Commission
in response to the Draft Report
Telecommunications Access Pricing Principles for Fixed Line Services**

Public Version

October 2010

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1. Executive Summary

- 1.1 Optus welcomes the ACCC's draft report on its review of access pricing principles for the declared fixed line services. The report signals a number of appropriate changes to the way access prices are determined on Telstra's fixed line network.
- 1.2 In particular, the ACCC has proposed to abandon its longstanding 'TSLRIC' pricing approach which involves repeated revaluations of Telstra's assets using a hypothetical replacement cost model. This approach has caused both significant industry uncertainty and unjustified high access prices, to the detriment of competition in the sector. The ACCC is to be applauded for its decision, which is both correct and long overdue. The increased predictability of the proposed new 'building block' pricing approach has the potential to enhance business certainty. Moreover, the proposed valuation of Telstra's network at its depreciated actual cost provides a better mechanism to ensure that Telstra is able to recoup its actual investment in the CAN and no more, having appropriate regard to the age of Telstra's assets and the fact that it has already recovered much of the original construction cost of the network. This reform will resolve the longstanding problem of valuing Telstra's network assets in a clear, transparent and practical manner.
- 1.3 Whilst the broad intent of the ACCC's proposed new approach is appropriate, much will rest on the detailed application of this methodology. It is welcome, therefore, that the ACCC has provided transparency of some of its detailed modelling of the proposed output prices. Based on our detailed examination of the ACCC's model, Optus takes this opportunity to highlight a number of material concerns with the proposed implementation of the ACCC's new approach. Ultimately, the proposed output prices fail a simple credibility test. The ACCC's new approach has led to a significant devaluation of the Telstra CAN (by as much as a half), yet the price of the most critical access service, the metropolitan Unconditioned Local Loop Service (ULLS), has remained stable. Optus' detailed concerns with the ACCC's approach are summarised as below.
- 1.4 First, there is a very substantial flaw in the cost allocation rules used in the new building block model which perpetuates a substantial anticompetitive cross-subsidy from access seekers to Telstra. The flaw results from the incorrect modelling assumption that the unit capital cost for duct and cable assets are equal for all services and uniform across the country. This creates a significant distortion between the interaction of the de-averaged pricing for the ULLS and the averaged pricing for Wholesale Line Rental and Telstra's Retail Line Rental pricing. Specifically, the ACCC's modelling ignores the fact that ULLS lines have a significantly lower cost profile compared to Telstra retail lines and resale lines given that ULLS use is overwhelmingly concentrated in low cost 'Band 2' urban areas. This violates the principle that access prices should be linked to actual costs. Optus estimates that correcting this error alone would result in a 44% reduction in the Band 2 ULLS price to the true cost-reflective level of \$8.94 / month (see Section 6 of this paper). If this error is not corrected, then ULLS access seekers will pay far more than their 'fair share' of Telstra's network costs and Telstra will significantly over recover

costs. Over the four year period the level of this cost over recovery borne by ULLS end-users is likely to exceed \$320 Million.

- 1.5 One readily apparent consequence of this allocation error is that the proposed access pricing for the ULLS is higher on average than pricing for the Wholesale Line Rental (WLR) service. That is, the price for buying a representative sample of access lines based on ULLS would be higher than the price of buying those same lines based on Wholesale Line Rental prices. This is patently wrong and demonstrates that the cost allocation rules are not properly cost-reflective. The WLR price should properly exceed the ULLS price on average, since the WLR service requires the use of additional assets which are not required for ULLS.
- 1.6 Second, the rules proposed for recovery of Telstra's ongoing capital and operating expenditure clearly provide Telstra with both the incentive and the means to 'game the system' and take in revenue substantially greater than its actual expenditure. Access prices must be clearly linked to expenditure which is likely to be prudently incurred. However, the expenditure forecasts the ACCC has been forced to make are unrealistically high and take no account of Telstra's own public statements that it will make substantial capex and opex savings in the coming years, especially given its intention to de-commission its network and migrate services to the National Broadband Network. The ACCC's forecasts are far too generous to Telstra. This is particularly difficult to comprehend given Telstra's unwillingness to provide its own data in response to the ACCC's request. Nor can the proposed approach be justified by reference to 'efficiency mechanisms'; in the current circumstances such mechanisms will fail to produce any efficiencies and are simply unnecessary. In Section 3 of this submission Optus will propose alternative methodologies for recovery of network expenditure which will reduce or eliminate the risk of over-recovery by Telstra.
- 1.7 Third, the proposed rate table for PSTN originating and terminating access (PSTN OTA) charges is outdated and does not take account of significant changes to traffic patterns in the seven years since the table was first developed. In particular it does not account for the rapid growth which has occurred in the take-up of mobile services or the substantial take-up in ULLS since 2006. Optus will demonstrate in Section 8 of this submission that both of these factors have driven significant changes to traffic patterns which will cause Telstra to recover significantly higher than anticipated revenue on a per minute basis from application of the ACCC's proposed rate table. That is, application of this rate table on an industry wide basis is likely to result in Telstra recouping substantially more than the headline average PSTN OTA rate of 1.1 cent/minute – and thereby recovering revenue well in excess of its actual costs. In order to prevent this problem, Optus will submit that the ACCC should move to a single national average rate PSTN OTA rate, consistent with the approach adopted for MTAS and WLR/LCS pricing, or at least amend its current proposed rate table to take account of the changes in traffic patterns noted by Optus.
- 1.8 Fourth, we note that the access prices set out in the proposed pricing determination are not clearly linked to the costs calculated by the ACCC's underlying model. For example, the proposed Band 2 indicative ULLS price has been at a level **c-i-c c-i-c** higher than the four year average cost calculated

by the model for Band 2 ULLS lines (see Section 9 of this submission). Equally, the WLR indicative price has also been inflated above the 4 year average, by **c-i-c c-i-c**. These discrepancies are left unexplained in the draft report – which suggests that in setting access prices, the ACCC may have been guided by an over-riding objective to achieve price continuity. This would be a mistake. These discrepancies will result in a significant cost over-recovery by Telstra over the four year period, and such a discrepancy will need to be corrected at some point. Moreover, it would defeat the purpose of the ACCC’s reform.

- 1.9 The decisions taken by the ACCC in this review will have a longstanding impact and may not easily be unravelled. Optus considers that the implementation issues addressed in this submission are significant. These must be addressed in order for the proposed new pricing approach to achieve the ACCC’s competition and investment objectives and prevent over-recovery by Telstra. If this means that the ACCC requires further time to finalise its pricing principles, then this would be time well spent. It would help to deliver a more robust set of pricing decisions, which in turn should reduce the risk of the pricing being subject to the sort of legal challenges that have so often bedevilled telecommunications industry regulation in the past. Optus would strongly encourage the ACCC to take a thorough and measured approach before finalising its new method and prices.
- 1.10 Optus will further contend that in the current consultation process, the ACCC should set out clear guidance as to its intended treatment of the ongoing payments Telstra will receive from NBNC_o in exchange for both access to Telstra infrastructure and the progressive migration of customers from Telstra’s copper and cable access networks to the NBN. Whilst the Financial Heads of Agreement is not binding on the parties, the agreement it foreshadows – and the substantial stream of revenue Telstra will receive under it – will have an immense impact on Telstra’s recovery of its network costs (since both the migration payments and the rental income are alternative means for Telstra to recover its costs, over and above wholesale access revenue, as discussed in Section 5 of this submission). End users are entitled to have confidence that they will not be required to compensate Telstra twice over for its network investment. Optus submits that it would be appropriate for the ACCC to signal clearly that any consideration Telstra receives will be taken into account to ensure there is no risk of over-recovery – and to explain how this will be achieved.

2. The New Pricing Approach

Moving from TSLRIC+ to BBM

- 2.1 The ACCC has stated its intention to adopt a building block model (BBM) with a locked-in regulatory asset base (RAB) when determining principles relating to the price of access to the declared fixed line services under Part XIC of the TPA.¹
- 2.2 Optus supports this reform. It is appropriate that the ACCC retire its current 'TSLRIC' pricing approach. The current approach, which requires valuation of Telstra's assets using a hypothetical replacement cost model, has been responsible for a significant overvaluation of the network and resulted in unjustified high access prices, to the detriment of competition in the sector. The prospect of repeated and unpredictable revaluations has caused significant industry uncertainty.
- 2.3 Optus submits that the increased predictability of the proposed new building block pricing approach has the potential to significantly enhance business certainty for access seekers, and enhance the confidence of both the access provider and access seekers that they would be able to recover the cost of their sunk investments. Improved certainty would assist all parties to make efficient decisions regarding future investment and general business plans.

Setting the initial RAB

- 2.4 The ACCC has proposed to take Telstra's past compensation into account when setting the opening RAB,² using a depreciated actual cost (DAC) valuation methodology.³
- 2.5 Optus agrees that it is appropriate to take account of past recovery by Telstra. The ACCC's proposal will avoid the problem of double recovery which would arise if past depreciation of existing assets was not taken into account, and ensure that Telstra is able to recoup its actual investment in the CAN and no more.
- 2.6 Further, Optus supports the ACCC's proposal to adopt a DAC methodology to value Telstra's network assets, rather than the alternative Depreciated Optimised Replacement Cost (DORC) method. Practical considerations suggest that a DAC method is the more appropriate approach of the two, since (compared to DAC) the DORC method is:
1. informationally and conceptually more complex;

¹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.17

² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.23

³ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.24

2. subject to a higher degree of uncertainty surrounding the estimation of parameter values;
 3. more prone to modelling error; and / or
 4. more dependent upon use of information that is asymmetrically held by an interested party (i.e. the regulated business).
- 2.7 By contrast, DAC is a clear, transparent and practical methodology which is able to be readily implemented by the ACCC using available information, without using complex models of efficient network design.
- 2.8 Optus agrees that the potential efficiency advantages of methodologies based on replacement cost including DORC are likely to be minimal in the current environment, in which the construction of alternate CAN infrastructure is unlikely. As the ACCC has noted, a DAC pricing approach allows the access provider to recover its actual capital costs.⁴ Moreover, the BBM allows investors to earn a fair return on their investment, which provides efficient investment incentives.
- 2.9 The ACCC has proposed to adopt an initial RAB value of \$7.5 billion for CAN assets and \$5.8 billion for Core assets, based on regulatory accounts data provided by Telstra.⁵
- 2.10 Optus notes that these values are conservative (in Telstra's favour). In an expert report submitted in support of Optus' submission in response to the Discussion Paper, adjustments were made to the DAC values reported in Telstra's regulatory accounts to account for changes in the price level and subsequent actual cost recovery (based on revenues received by Telstra). This resulted in values for Telstra's CAN today of between \$2 billion and \$6 billion.
- 2.11 Further, the ACCC has noted that relevant factors exist which would tend to further reduce the value of the network assets, including the possibility of inefficient or imprudent investments and also issues relating to asset lives.⁶ It has not taken these factors into account due to a lack of reliable data. The ACCC's approach is a further indication that its DAC valuations of Telstra's assets (\$7.5 billion for the CAN and \$5.8 billion for the Core) are conservative, and should be considered ceiling values.

⁴ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.26

⁵ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.24

⁶ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.28

3. Capital and Operating Expenditure

- 3.1 Under the ACCC's proposed new BBM pricing approach, forecasts of Telstra's capital expenditure (capex) and operating expenditure (opex) are required as inputs into calculating prices for the estimation period.⁷
- 3.2 In this section Optus has set out a number of concerns regarding the ACCC's proposed approach to Telstra's capex and opex, which is likely to result in inflated forecasts and a significant over-estimate of Telstra's revenue requirement. This is an inappropriate result, particularly given Telstra's recent public statements on cost savings, and CFO John Stanhope's recent public admission that "*as you probably know, we're not spending a lot of money on the copper network now...*"⁸
- 3.3 In this section Optus proposes alternative methods for capex and opex forecasting and allocation which will reduce the risk of over-recovery by Telstra.
- 3.4 Further, Optus considers that the rules proposed for recovery of Telstra's ongoing capital and operating expenditure clearly provide Telstra with both the incentive and the means to 'game the system' and take in revenue substantially greater than its actual expenditure. Optus considers that in the current circumstances facing Telstra, the proposed efficiency mechanisms are both unnecessary and counter-productive.
- 3.5 Before turning to these concerns, however, we consider the information difficulties faced by the ACCC in this area as a result of Telstra's failure to provide data.

Information issues

- 3.6 The ACCC has been unable to obtain from Telstra any information in relation to forecast capex and opex.⁹ Optus notes that Telstra is a publicly listed company which regularly provides updates to its shareholders regarding revenue and profit expectations, including planned expenditure. We note that Telstra has recently reassured investors that it plans to maintain its dividend policy.¹⁰ Opex and capex forecasts are required for the internal budgeting and planning purposes of telecommunications companies. Consequently, Telstra's claimed inability to provide suitable information to the ACCC is unconvincing. Optus submits that the ACCC is entitled to draw the inference that Telstra's withholding of forecast data is a strategic practice.

⁷ Capex is not a direct component of the revenue requirement but is rolled into the RAB, which is used to determine the return on and return of capital.

⁸ Telstra, NBN conference call transcript, 21 June 2010

⁹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p64

¹⁰ Reuters, Mon Oct 25, *Australia's Telstra: broadband talks progress well*, <http://www.reuters.com/article/idUSSGE6900N120101026>

- 3.7 The ACCC has stated that it intends to make a record keeping rule (RKR) to obtain forecast capex and opex data from Telstra. Optus supports this proposal but notes that, considering the new RKR would have to be subject to further consultation, the forecast data would not be available for the purposes of this review.
- 3.8 Optus notes that the ACCC also has the power to issue a s155 notice to Telstra. S.155 provides the ACCC with statutory power to require Telstra to provide the requested information within the time and manner specified in the notice. Optus considers a s155 notice is appropriate given that the ACCC is required to conclude this review before the end of this year.
- 3.9 In the absence of Telstra's own data, the ACCC has generated its own forecasts, relying on limited information. Unfortunately, it appears that the expenditure forecasts the ACCC has been forced to make are unrealistically high, as is discussed below. Given Telstra's failure to provide its own data in response to the ACCC's request, the proposed adoption of generous forecasts is unjustifiable. This cannot encourage Telstra to submit the requested information, now or in future. Optus submits that the ACCC should take a firm approach with Telstra and adopt 'low end' forecasts for capex and opex.

Capital expenditure

The ACCC's approach

- 3.10 In constructing capex forecasts, the ACCC has taken the following steps:¹¹
- obtained the last 5 years of capex from Telstra's annual reports;
 - made assumptions regarding which reported expenditure relates to the relevant assets and summed to obtain a total figure for each year;
 - taken the average of the calculated relevant capex;
 - indexed the series using equipment and labour price indexes obtained from the ABS;
 - maintained the average constant in real terms over the duration of the forecast period; and
 - allocated capex to the asset classes by taking into account the asset size, the remaining asset life and demand.
- 3.11 Optus considers that the ACCC estimates of Telstra future capex are likely to be inflated, since it is not appropriate for the ACCC to:
- use a five year average of Telstra's past capex reported;

¹¹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp64-65

- keep the average capex constant over the duration of the regulatory period; or
- allocate capex to asset classes without a stated methodology.

3.12 These concerns are each addressed in turn below.

(1) Averaging of Telstra’s past capex

3.13 Optus objects to the ACCC’s construction of a capex forecast based on a five year average of Telstra’s past annual capex figures. Generally, the assumption that future capex will resemble past capex appears difficult to sustain.

3.14 First, it is unreasonable to expect future investment to be equal to a historical average in a network with declining demand. Revenues from Telstra’s fixed network are in decline due to the reducing demand for fixed services combined with the almost certain migration to the NBN. The relationship of past expenditure to future expenditure becomes weaker as demand becomes less certain. As revenues fall, costs will need to fall as well in order for Telstra to maintain profits. Network businesses with fixed infrastructure characterised by high costs and long asset lives cannot continue to invest in fixed infrastructure when revenues are declining. Indeed, CEO David Thodey has publicly stated that Telstra’s capex to revenue ratio is not sustainable¹²:

“This has been a very heavily capital-oriented company, long term investment, and we need to be very different in terms of that going forwards. I think the good telcos have moved to that place. When we talk about 13-14% capex to revenue ratios, that is not sustainable, full stop; when we look forward, we will see a significantly different structure.”¹³ [emphasis added]

3.15 Indeed, the decline in capex is already apparent from recent reporting. Annual capex figures reported in Telstra’s annual report have been declining, year on year. CAN capex (indexed) has fallen 41% from \$928 million in 2005-06 to \$547 million in 2009-10. CORE capex (indexed) has fallen 28% from \$1,019 million in 2005-06 to \$732 million in 2009-10. The year on year change is summarised below.

	2005-06	2006-07	2007-08	2008-09	2009-10
CAN (indexed)	928	691	848	719	547
YoY change		-26%	23%	-15%	-24%
CORE (indexed)	1019	1663	1182	1013	732
YoY		63%	-29%	-14%	-28%

¹² In 2010, Telstra’s total capex accounted for 14% of its sales revenue; Telstra, *Annual report 2010*, p50

¹³ Communications Day, “Thodey talks new alliances, capex cuts: but steers clear of politics,” 11 October 2010

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- 3.16 The recent decline in capex levels suggests that, at the very least, the ACCC should use the capex figure for the most recent year (rather than a five year average) as its base for estimating future capex levels.
- 3.17 Moreover, it suggests that further decline cannot be ruled out – a hypothesis which is explored in the following section.

(2) *Keeping capex constant over the duration of the regulatory period*

- 3.18 The ACCC’s assumption that capex levels will remain constant over the duration of the regulatory period is unrealistic. Optus considers that a decline in capex over the course of the regulatory period is far more likely, for a number of reasons.
- 3.19 First, as noted above, a declining trend is already evident. Optus considers that the ACCC should take the recent decline into account and project it forward.
- 3.20 Second, it is likely that capex on Telstra’s fixed network – already low by its own admission – will continue to fall as it decommissions its fixed network in the coming years and progressively migrates its voice and broadband services from the copper and cable networks to the NBN. Telstra has acknowledged this likelihood: in June this year, in response to a question on whether there would be capex or opex avoidance in the context of shutting down the copper network over time, Telstra CFO John Stanhope responded that “...we have factored in some lower CAPEX on the CAN, but as you probably know, we’re not spending a lot of money on the copper network now. Of course we’re repairing or replacing and making sure we’re providing service to our customers, but nevertheless there will be some savings and it is factored into our financial modelling.”¹⁴ [emphasis added]
- 3.21 This expectation has been confirmed by Telstra CEO David Thodey. Thodey has expressed confidence that capex savings will help lock in profits, particularly if the Telstra – NBNCo agreement goes ahead, freeing up Telstra’s current capex spend on its fixed network. Specifically, he stated that:

“...when we look at our numbers and roll them going forwards, we do see that the Capex intensity will reduce, because the capex responsibility for the fixed network moves somewhere else in an NBN world –should that happen.”¹⁵ [emphasis added]
- 3.22 This reduction in capital intensity is likely to begin *prior to* actual customer migration. Since capex responsibility will be borne by another entity in future, Telstra’s incentive will be to shift costs to that entity (to the extent possible), by postponing or cancelling inessential capex that it would in ordinary circumstances have carried out.

¹⁴ Telstra, NBN conference call transcript, 21 June 2010

¹⁵ Communications Day, “Thodey talks new alliance, capex cuts: but steers clear of politics”, 11 October 2010

- 3.23 Third, capex is likely to decrease as a result of significant decreases in equipment prices in recent years. For example, prices for IP routers have decreased by **CiC CiC** between 2006 and 2010 and are likely to continue to fall in line with continuing technology advances. Optus refers the ACCC to Appendix A for further details about decreasing prices for equipment including routers and fibre cables.
- 3.24 For all the reasons set out above, Optus submits that the ACCC's approach of averaging Telstra's capex in the past five years and maintaining a constant profile will lead to a significant over-recovery for Telstra.
- 3.25 Optus proposes that in order to determine more realistic capex forecasts for Telstra, the ACCC should begin with the 2010 capex estimate from Telstra's Annual Report and apply a declining profile for the remainder of the regulatory period. The yoy change from 2008-09 to 2009-10 for CAN capex (index) was -24% (according to Telstra's annual report). Similarly, the yoy change from 2008-09 to 2009-10 for CORE capex (index) was -28%. Optus therefore considers that a conservative estimate would be to adopt a 24% decline year on year for CAN and a 28% decline year on year for CORE capex. The resulting forecasts are shown in the table below.

Table: Forecast capex for CAN and CORE

	2009-10	2010-11	2011-12	2012-13	2013-14
CAN	547	416	316	240	182
		-28%	-28%	-28%	-28%
CORE	732	527	379	273	197
		-24%	-24%	-24%	-24%

- 3.26 Optus considers that these are conservative estimates considering the reduction in capex is likely to become more rapid as Telstra decommissions its fixed network.

(3) Allocate capex to asset classes without a clear methodology

- 3.27 It is not clear from the draft report how total capex has been allocated between the relevant asset classes. Whilst the ACCC has stated the factors which were taken into account, it is not transparent how this was applied and what weighting has been used. Optus is concerned that the lack of a systematic approach to allocation could inadvertently lead to cross-subsidisation of one service by another.
- 3.28 For the CAN, the largest proportion of capex was allocated to ducts and pipes (40%) and copper cables (17%). This allocation appears unrealistic. Given the forthcoming migration of customers from Telstra's fixed network to the NBN, it is unlikely that Telstra will incur significant new expenditure on ducts and pipes and copper cables in

the coming years.¹⁶ The forecast capex allocated to ducts and pipes and copper cables should therefore be minimal.

- 3.29 In addition, Telstra announced in March 2010 that it would no longer deploy copper cables in new housing estates.¹⁷ Indeed, under the Telecommunications Legislation Amendment (Fibre Deployment) Bill 2010, the Minister will be able to specify the types of real estate development projects in which fixed lines will need to be optical fibre.¹⁸ Further, from 1 January 2011, NBNCo will act as wholesale provider of last resort in new developments constructed within, or adjacent to, NBNCo's long term fibre footprint. NBNCo will cover the costs of fibre infrastructure whilst the developers and/or property owners will be required to cover the costs of trenching and ducting.¹⁹ These developments, which effectively mean that Telstra will no longer be required to install copper cables and/or fibre in new estates, should be taken into account by the ACCC for the purposes of forecasting capex and allocating capex to the ducts and pipes and copper cables categories.
- 3.30 Finally, when existing copper cables require replacement due to deterioration or other circumstances, it is now likely that Telstra will replace these assets with fibre cables instead of copper. This is likely for reasons of network modernisation as well as cost, given that fibre is now cheaper than copper to install (as acknowledged in the draft report). Telstra's network modernisation in the South Brisbane exchange area provides a current example.
- 3.31 Optus considers that the allocation of capex to ducts and pipes and copper cables should in reality be minimal compared to other asset classes. If the proposed allocation is retained, it will result in a significant over-allocation of capex to the ULLS, with negative implications for allocative efficiency and competition. In order to avoid this result, Optus submits that the ACCC should adjust its allocation of capex.

Operating expenditure

- 3.32 The ACCC has taken the following steps in constructing its opex forecast:
- obtained from Telstra's RAF reports the opex over the past 5 years;
 - taken the average of the reported opex;

¹⁶ That is, it will not incur significant 'business as usual' expenditure on these assets. It may well incur decommissioning expenditure, specifically required in order to migrate customers to fibre. These costs are not attributable to access services on the existing copper network and should not be borne by current access seekers. Indeed, it is likely that Telstra will be specifically compensated for such costs by NBNCo through the FHoA (as discussed in section 5 of this submission).

¹⁷ <http://www.theaustralian.com.au/business/broadband-doubts-hit-property-developments/story-e6frg8zx-1225911611319>

¹⁸ http://www.dbcde.gov.au/broadband/national_broadband_network/fibre_in_new_developments

¹⁹ http://www.dbcde.gov.au/broadband/national_broadband_network/fibre_in_new_developments

- increased the RAF values by 10% to reflect an allocation of corporate overheads;
- indexed the series using equipment and labour price indexes obtained from the ABS;
- maintained the average constant in real terms over the duration of the forecast period; and
- allocated opex based on undepreciated asset values also from the RAF.

3.33 Optus submits that the ACCC's forecasts of Telstra's opex are likely to be inflated because:

- historic opex and capex were obtained from different sources;
- average opex as reported in Telstra's RAF is unlikely to be representative of current opex; and
- opex is unlikely to remain constant over the duration of the forecast period.

(1) *Different sources of historic capex and opex*

3.34 The ACCC obtained opex information for the past 5 years from Telstra's RAF reports. However, historical capex was obtained from Telstra's annual reports. It is unclear whether different accounting frameworks are utilised for these different reports. If so, classifications between opex and capex may result in inconsistent allocations which could lead to overlap between categories if different sources are utilised. The RAF accounting framework is also worth examining to ensure that reported opex does not already include indirect expenditure such as overhead allocations.

3.35 Accordingly, Optus suggests an additional level of caution be adopted by the ACCC in utilising both its capex and opex forecasts.

(2) *Use of average opex*

3.36 Optus questions the ACCC's approach of utilising a five year average of Telstra's reported opex in the RAF. The ACCC has not provided any explanation for this approach compared to another, except that it intends to obtain forecasts from Telstra. Also, since the reported opex is not available to Optus, it is not clear whether there is any trend observable in the data which may be important to take into account when forming expectations regarding future expenditure.

3.37 Optus submits that Telstra has an incentive to minimise opex on its fixed line network as a result of anticipated future migration to the NBN. Since Telstra will decommission its fixed network in the coming years, it would be reasonable to expect that Telstra will adopt a reactive approach to operating and maintaining its fixed network. That is, maintenance will only occur in the event of emergencies and when

it has no alternative to repairing the network. As such Telstra's opex should expect to fall in the coming years.

- 3.38 On the other hand, given that Telstra has faced a recent decline in its fixed business, opex may have already started to decline on the fixed network. Indeed, it was recently reported that Telstra would lay off up to 6,000 workers (or 15% of the workforce).²⁰ At the same time Telstra has announced \$1 billion in incremental opex for new projects and growing areas such as mobile.²¹ Whilst the segment of the business to which the announced cuts in opex relate has not been identified, it would be consistent with Telstra's incentives to assume that the opex cuts relate in large measure to the declining part of Telstra's business, namely the fixed network. Optus submits that in the absence of verifiable data from Telstra, the ACCC should make this assumption.
- 3.39 Accordingly, Optus submits that the average of Telstra's past opex is unlikely to be representative of current opex and could likely lead to an inflated forecast.

(3) Constant trend for the duration of the regulatory period

- 3.40 Optus objects to the ACCC's assumption that average opex will be maintained at a constant level over the duration of the regulatory period. Our objection is for the same reasons discussed in the capex section above, being:
- it is likely that capex and opex will continue to fall as Telstra decommissions its fixed network in the coming years;
 - equipment prices have fallen significantly in recent years and are expected to continue to fall in real terms; and
 - Telstra has refocused its opex investments away from fixed to other areas such as mobile and the NBN.
- 3.41 For an elaboration of these points, Optus refers the ACCC to its submissions in the capex section above.

Optus' proposed approach

- 3.42 Optus proposes that the ACCC utilise the most recent available year of opex as the base year (or starting point) for forecasting opex. This is an approach commonly accepted by the AER in determining the regulated prices for electricity and gas. This is also consistent with the ACCC's contention that Telstra's past expenditure can be assumed to be efficient.²²
- 3.43 For the remainder of the pricing period Optus submits that a trend be utilised based on the expected change in services in operation for the

²⁰ *The Sunday Telegraph*, 'Telstra chiefs planned exclusive party as it axed 6000 staff', 3 October 2010

²¹ Telstra, Investor day transcript, 29 September 2010, pp18-20

²² ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services – Draft report, September 2010, pg81.

fixed network. Since the number of lines would be expected to drive opex, as the number of services decline it would be expected that opex too will decline. Of course as the ACCC noted, as assets age maintenance costs would be expected to increase. However as noted, Telstra has a very strong incentive to only incur expense when absolutely necessary. Further, as volume and customer numbers fall, faults and call-outs are likely to occur less frequently than if the assets were fully utilised. Other opex costs such as call centres and billing, which are related to the number of customers, may also fall.

- 3.44 Optus submits that its proposed approach will assist in making access charges cost-reflective and minimise the likelihood of over-recovery by Telstra.

Efficiency mechanisms

- 3.45 The ACCC postulates that the regulatory framework should provide the access provider with the appropriate incentives to only commit capital and operating expenditure which is necessary to provide the required services in a safe and effective manner.²³ To achieve this objective, the ACCC has proposed to adopt a mixture of ex-ante and ex-post review approaches, including the proposed “efficiency carry-over mechanism”. Optus considers that the ACCC’s proposed efficiency mechanisms are unnecessary and counter-productive, for reasons developed below.
- 3.46 Efficiency carry-over mechanisms were originally developed to address the widely held view that the predominant form of regulation (‘rate of return’ regulation) did not provide sufficient incentives for regulated firms to reduce costs, innovate and undertake efficient investments. This is because the firm faced only a very limited risk that any costs it incurred would not be recovered through regulated tariffs. As a result, capital over-investment (‘gold plating’) and inefficient management (‘managerial slack’) could persist.
- 3.47 These problems arose because of the regulated firm’s information advantage over the regulator. Efficiency carry-over mechanisms were intended to overcome the information problem by providing incentives for the regulated firm to reveal its efficient costs by rewarding cost reductions. In turn, the regulator achieves a greater understanding of costs and eventually savings are passed through to end users through lower tariffs.
- 3.48 Optus supports the contention that the regulatory framework should provide appropriate incentives. However, prior to adopting specific mechanisms Optus submits that the ACCC should also consider the commercial environment and incentives facing the access provider and how they may interact with the incentives inherent within the regulatory framework.

²³ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010,, pg38.

- 3.49 It is Optus' contention that Telstra already has sufficient external incentives to minimise costs, in particular:
- *declining demand* – the recent steep decline in demand for fixed line services was far more rapid than expected, indicating that forecasts may be less reliable for setting prices than previously or in other industries. Therefore, in order to maintain margins, Telstra will need to adjust prices and/or costs for the change in volume. Depending on the relationship between demand changes and the length between price changes Telstra will be forced to cut costs to meet publicised earnings guidance;²⁴ and
 - *the agreement with NBNCo* – with expectations to migrate its fixed line customers and lease its ducts and pipes eventually to another party, Telstra has an incentive to defer capital and operating expenditure in order to maximise the return from the transaction.²⁵ It is common practice for a firm to minimise expenditure on a soon to be retired asset ('sweat the asset') in order to maximise its return. This is consistent with public statements made by Telstra in relation to declining expenditure on its copper network.²⁶
- 3.50 Accordingly, specific efficiency mechanisms are not necessary at this time. As Optus submitted in response to the Discussion Paper, further efficiency mechanisms are not necessary because:²⁷
- it is unlikely that significant network investment will be required;
 - efficiency concerns can be addressed through expert review; and
 - it is more likely to lead to adverse incentives to take advantage of information asymmetry than address genuine efficiency problems.
- 3.51 Furthermore, in order for the benefits from incentive mechanisms to flow through to end users, a significant number of regulatory reviews is typically required. This experience allows the regulator to 'get to know' the business and provide sufficient incentives for the firm to reveal information. As a result of the forthcoming transition to the NBN, it is unclear if sufficient time will be available in this regulatory regime to permit the ACCC to develop this required experience.
- 3.52 Optus considers that Telstra has strong incentives to inflate its forecasts in order to receive substantial reward under an efficiency mechanism. Without an efficiency mechanism all deviations between forecast and outturn expenditure are returned to end users through lower prices. But with the proposed efficiency mechanism, Telstra is allowed to obtain the benefit of all such deviations for itself. It is

²⁴ John Stanhope, CFO, Presentation "Financial Update", Telstra Investor Day, 29 September 2010, slide 7.

²⁵ Telstra CEO David Thodey stated that "*capex responsibility for the fixed network moves somewhere else in an NBN world – should that happen.*" Communications Day, 'Thodey talks new alliance, capex cuts: but steers clear of politics', 11 October 2010.

²⁶ Telstra CFO John Stanhope stated that "*we have factored in some lower CAPEX on the CAN, but as you probably know, we're not spending a lot of money on the copper network now.*" Telstra, NBN conference call transcript, 21 June 2010.

²⁷ Optus, Public Submission to Australian Competition and Consumer Commission on Telstra's Access Undertaking for the Unconditioned Local Loop Service: Response to Discussion Paper, August 2008, pp32-33.

critical to recognise that such deviations are not necessarily the result of efficiency on Telstra’s part. Rather, as noted in this section, deviations are far more likely to result from a) inflated forecasts and b) Telstra’s incentives to minimise its own expenditure in the period immediately before its own fixed network is decommissioned.

- 3.53 Optus submits that the access provider’s compensation should be linked as closely as is practicable to actual expenditure by Telstra. A close relationship between costs and prices can be ensured by regularly ‘trueing up’ costs (at or before the next regulatory review) to remove (add) any benefit (loss) resulting from deviations in outturn expenditure from the forecasts. Specifically, the access provider will provide evidence of its actual costs at (or before) the end of the regulatory period and this data will be compared to the forecast. Any deviation will be taken into account in the calculation of the forecast for the set of prices in the following period. The table below provides a numerical example.

Table: Numerical Example of Regulatory ‘True Up’

	Year 1	Year 2	Year 3	Total
Regulatory Period 1				
Forecast	100	100	100	300
Actual	100	95	95	290
Difference	-	-5	-5	-10
Regulatory Period 2				
Forecast	95	95	95	285
Carry over	-10	-	-	-10
Net forecast	85	95	95	275

- 3.54 In the above example, the access provider has an approved forecast of \$100 for each year. At the end of the regulatory period the access provider submits its actual costs of \$100, \$95 and \$95 which are lower than the forecast in the last two years. Accordingly, the forecast for the following regulatory period will be lower than the previous, being \$95 for each year.
- 3.55 However, the forecast for the first year of the new period is adjusted to take account of the deviation between forecast and actual expenditure in the previous period. Specifically, the difference from the previous period is applied to the first year, which makes it \$10 lower than the forecast \$95. Without this ‘true up’ the access provider would have retained that \$10 difference from the first period, meaning that end users paid higher prices than otherwise necessary. The true up thus allows for prices to bear a closer (albeit lagged) relationship to costs. Optus submits that if this link is made, prices will be cost-reflective, competition will be promoted and Telstra will not over-recover.
- 3.56 The length of the regulatory period is also important to minimise the potential for access seekers to pay prices significantly above underlying costs (regardless of whether there is true up). This is because forecasts are determined at a specific time based on a number of factors and circumstances which means that the longer the

forecasting period the further actual events can potentially deviate from the circumstances that drove expectations.

- 3.57 Indeed, Optus has submitted in response to the Discussion Paper that a regulatory period of no more than 3 years be adopted. Telstra also submitted that a shorter regulatory period be adopted as the uncertain demand conditions and the advent of the NBN render capital and operating cost forecasting difficult for a period longer than one or two years.²⁸
- 3.58 The ACCC needs to be mindful that opportunities to correct errors will be limited. This will not be a long lived regulatory regime: services will begin moving off copper within two years. It follows that the ACCC must move swiftly to reverse any over-recovery by Telstra as soon as it is identified.
- 3.59 Consequently, the ACCC's proposed four year period should be reduced to no more than three years and deviations between forecast and outturn expenditures reconciled at the following review (if not before).

Service quality mechanisms

- 3.60 Optus supports the ACCC's decision to not introduce any additional service quality incentives at this time.

²⁸ Telstra, *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services – Telstra's Response to the ACCC's Discussion Paper*, 26 February 2010, pg27.

4. Weighted Average Cost of Capital (WACC)

- 4.1 Optus agrees with most elements of the approach applied by the ACCC to estimate the WACC. Specifically, Optus supports:
- a market risk premium of 6% which is consistent with regulatory precedent and financial market practitioners. Optus has previously submitted that 6% is an appropriate estimate for Telstra's declared fixed line services;²⁹
 - debt issuance costs of 0.085% that was estimated utilising the methodology developed by the Allen Consulting Group (ACG) and applied in previous regulatory decisions by the ACCC; and
 - an imputation factor of 0.65 which is consistent with the outcome of the Australian Energy Regulator's (AER) review of WACC parameters for electricity transmission and distribution businesses.³⁰
- 4.2 Nevertheless, Optus considers that the WACC calculated by the ACCC is likely to exceed the appropriate level and lead to over-recovery, since the proposed value for the equity beta parameter over-compensates Telstra for the level of systematic risk that it actually faces.
- 4.3 The methodology adopted by the ACCC yields a real vanilla WACC of 6.39%.³¹ Optus submits that this value should be viewed as a ceiling since there is an element of upward bias inherent in the estimation of the equity beta. The value of the equity beta is a material determinant in the overall WACC estimation. Accordingly, Optus discusses the bias in the section below and proposes an alternative, lower value.

Equity Beta

- 4.4 The ACCC considered that benchmarking Telstra with comparable firms is the most appropriate method for estimating the equity beta.³² Optus supports this approach.
- 4.5 The ACCC utilised telecommunications firms from selected countries in the Organisation for Economic Cooperation and Development (OECD) as comparable businesses. Monthly and weekly estimates of equity betas were then obtained and de-levered to take into account differences in gearing structures between the businesses.

²⁹ Optus, Public Submission to Australian Competition and Consumer Commission on Telstra's Access Undertaking for the Unconditioned Local Loop Service: Response to Discussion Paper, August 2008, pg52.

³⁰ AER, Final Decision – Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters, May 2009.

³¹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg66.

³² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg70.

- 4.6 The simple average of the asset beta results (0.39) was approximately 20% lower than the average of the results in the 2008 ULLS undertaking decision (0.47). The ACCC has suggested that the decrease is due to the effect of the global financial crisis (GFC) as telecommunications companies' share prices were not as volatile relative to other companies' share prices. However, the ACCC states:

*“While the most recent benchmark estimates for asset beta are likely to have been influenced by the global financial crisis, the ACCC considers that any downward bias in the benchmark value would be offset by the different composition of the benchmarked firms’ businesses compared to Telstra’s CAN.”*³³

- 4.7 Optus is of the view that excluding the effect of market circumstances by comparison with the structure of the sample is inappropriate. It is not uncontroversial to exclude market event impacts. Moreover, the difference between the estimates may be due to factors other than the occurrence of the GFC. For example, since the betas were estimated for the 2008 ULLS decision, the sample size has been reduced by two.

- 4.8 The conclusion that the impact of the GFC would be cancelled by any bias resulting from the structure of the businesses also depends on the relative size of the bias for each factor. The difference of 0.08 in the benchmarking estimates for asset betas represents the maximum bias that can be related to the effect of the global financial crisis on the share price of telecommunication firms. However, there is no explicit consideration for varying business structures of the selected firms except this statement:

*“The systematic risk associated with business lines like mobile communications is likely to be significantly higher than the systematic risk associated with fixed line services.”*³⁴

- 4.9 To illustrate the potential size of the bias Optus has had regard to the Ofcom decision for BT's copper network. Optus has previously submitted that the ACCC should consider Ofcom's approach of disaggregating the estimate of BT's equity beta in order to reflect differing levels of systematic risk faced by different parts of the business. Ofcom concludes that an equity beta of 0.9 for the copper network is appropriate compared to a firm-wide equity beta of 1.1.³⁵ This 0.2 difference in equity beta converts to a 0.12 difference in the associated asset betas, which is larger than the maximum difference that could be related to the GFC bias. Consequently, Optus submits that the downward bias from the GFC would be *more than* offset by the different composition of the benchmarked firms.

³³ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg72

³⁴ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg72

³⁵ Ofcom, *Final Statement: “Ofcom’s approach to risk in the assessment of the cost of capital”*, August 2005, pp3-4 as cited in Optus, *Public Submission to Australian Competition and Consumer Commission on Telstra’s Access Undertaking for the Unconditioned Local Loop Service: Response to Discussion Paper*, August 2008, pg53.

4.10 Furthermore, the equity beta that the ACCC adopts (0.7) is consistent with an asset beta of 0.421, which is higher than that indicated by the most recent benchmarking results. Therefore, if the GFC-related downward bias is expected to be offset by the upward bias in utilising firm wide betas, there is additional upward bias introduced by increasing the asset beta. Accordingly, Optus submits that the equity beta should be lower than 0.7 because:

- the downward bias from the post-GFC sample would be more than offset by the upward bias of the different composition of the firms' businesses (that is, Telstra's CAN is significantly less risky than the benchmark sample); and
- the ACCC has selected an asset beta that is higher than the one estimated by the post-GFC sample.

4.11 In arriving at its equity beta estimate the ACCC states that it took into account regulatory stability and the approach adopted in recent ACCC and AER decisions for other regulated utilities. Specifically, it states:

*"that it has taken a conservative approach in applying a value for the equity beta for Telstra's CAN that is at the top end of the range of empirical estimates in the AER's WACC review."*³⁶

4.12 Empirical estimates compiled for the AER's WACC review yielded an equity beta range of 0.41 to 0.68.³⁷ However, the benchmark gearing utilised in these studies was 60%, which is the benchmark utilised across the electricity and gas industries in Australia. Therefore, when the asset beta value of 0.421 is utilised with a benchmark gearing level consistent with Telstra (40%), the equity beta increases to 1.049. Therefore, the equity beta adopted by the ACCC is significantly *outside* the AER's range. This suggests the proposed value is too high.

4.13 Optus has previously submitted that investments in the CAN have substantially similar characteristics to investments in other natural monopoly assets, such as gas and electricity distribution networks. These shared characteristics include:³⁸

- cost structures – high upfront construction costs and relatively low ongoing maintenance costs;
- limited competition from other services; and
- derived demand for services from the purchasing decisions of a large number of small end customers (mainly households).

4.14 Indeed, the ACCC repeated its statement that:

³⁶ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg73

³⁷ AER, Final Decision – Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters, May 2009, pg343

³⁸ Optus, *Public Submission to Australian Competition and Consumer Commission on Telstra's Access Undertaking for the Unconditioned Local Loop Service: Response to Discussion Paper*, August 2008, pg54.

“The appropriate WACC for the ULLS is one based on a business providing access to a fixed line customer access network.”³⁹

- 4.15 Accordingly, the ACCC should explicitly take into account the equity beta values set by regulators of other fixed line assets but with adjustments for the relevant gearing levels. Other than the AER decision referenced above, the ACCC makes reference to two other recent decisions:⁴⁰
- Australia Post: equity beta of 0.463 and asset beta of 0.355; and
 - Draft pricing principles for rural water corporations: equity beta of 0.7.
- 4.16 Although recent decisions, the ACCC has not presented these considerations with the benchmark gearing level associated with Telstra. When the asset beta from the Australia Post decision is utilised with Telstra’s benchmark gearing the resulting equity beta is 0.59. The asset beta associated with 0.7 from the Water decision associated with a gearing of 60%⁴¹ is 0.281. When this is applied to Telstra’s benchmark gearing the equity beta yielded is 0.467. Therefore, this evidence also supports a lower equity beta than the one adopted by the ACCC.
- 4.17 The ACCC states that it has also taken into account regulatory stability in arriving at its decision. Regulatory stability, or certainty, as described by the ACCC in its interpretation of the legislative criteria⁴² does not require price level stability or parameter stability. Rather, Optus understands that regulatory certainty and stability is achieved through predictable and consistent application of the framework and principles for determining services and prices that are to be regulated.
- 4.18 Given the evidence submitted by the ACCC, Optus submits that a lower equity beta value is warranted. Specifically, Optus considers an equity beta based on the recent benchmarking result of 0.65 to represent a ceiling given the evidence from the AER’s WACC Review. Further, Optus urges the ACCC to adjust its benchmarking sample according to the proportion of the benchmarked businesses that closely resemble Telstra’s CAN.

³⁹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg72

⁴⁰ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pg73

⁴¹ ACCC, *ACCC pricing principles for price approvals or determinations under the Water Charge (Infrastructure) Rules*, Draft Report, July 2010, pg52

⁴² ACCC, *ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, Section 3 and Appendix D and ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Discussion Paper, December 2009, Section 3 and 4.114.

5. Financial Heads of Agreement (FHoA) and Depreciation

- 5.1 The ACCC has acknowledged Optus' concerns regarding overcompensation as a result of the FHOA between Telstra and NBNCo raised in our letter of 13 July 2010. Optus submitted that not only should the FHOA be considered in setting the initial RAB but that both forms of payments should be taken into account by the ACCC in setting access prices for the remaining life of Telstra's network.⁴³ By taking into account *all* payments Telstra will receive in relation to the relevant assets the ACCC can ensure that Telstra is not overcompensated by access seekers for the use of the network.
- 5.2 However, the ACCC has not given substantial consideration to the FHOA in setting indicative prices except to say that "*it will take into account any migration payments received by Telstra and any impact that de-commissioning the network may have on the RAB.*"⁴⁴ This statement is of concern since it refers only to migration payments and not to lease payments, which should to a significant extent be treated in the same way as migration payments.
- 5.3 Optus considers that it is important for the ACCC to state its intentions to consider these interactions, and allow for its decision to be re-opened if necessary. However, it would also be appropriate for the ACCC to state *how* it will take payments into account in the event that a binding agreement is enacted in future. A binding agreement need not be in place for the ACCC to provide such guidance.
- 5.4 Optus notes that the ACCC is able to exercise discretion as to the timing of recovery of capital costs, through setting the depreciation profile. This feature allows the ACCC to take the FHOA into account prior to an agreement being finalised. Accordingly, in this section Optus will discuss how depreciation should be calculated given the FHOA as well as potential approaches for considering expected payments once a binding agreement is in place.

Treatment of any Future Payments from NBNCo

- 5.5 Optus understands that under the FHOA, there are two types of payments: migration and lease payments. Each is considered separately below.

Migration Payments

- 5.6 Optus submits that the migration payments should be viewed as a 'return of capital' to Telstra shareholders for capital invested in the CAN. Accordingly, once received Telstra should no longer earn either a return on or a return of capital associated with the asset for which

⁴³ Optus, Letter to the ACCC – Review of Access Pricing Principles for Fixed Line services, 13 July 2010.

⁴⁴ ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services – Draft Report, September 2010, pg29.

the payment was made. This means that the asset value should be removed from the RAB.

- 5.7 In doing so, the payment value can be treated similarly to an asset disposal since Telstra will no longer be able to use the asset to provide declared services. Accordingly, the payment value can be deducted from the RAB and so a return on and return of capital will no longer be included in the revenue requirement associated with those assets.
- 5.8 It has been argued by some that to recognise payments made to Telstra by NBNC Co in this way amounts to a deliberate adjustment to access prices to *offset* whatever benefit Telstra has negotiated through the NBNC Co deal. However, this argument misunderstands the nature of a RAB, which should be understood as a record of the outstanding value of capital invested and not yet recovered. The RAB must be adjusted whenever anything occurs which changes that outstanding capital value. Understood in this way, when the ACCC changes the value of the RAB it is not making a deliberate intervention (in order to offset some event); rather it is simply reflecting an event which has occurred in the real world (in this case, the receipt of payments by Telstra in compensation for giving up its network). Failure to reflect these payments in the RAB would mean that investors were fully compensated for their capital twice over: once through NBNC Co payments and again through access prices.
- 5.9 However, to ensure equitable treatment between end-users (those that are migrated early and those migrated later), the present value of all payments may be deducted (once known) such that prices are stable over the remaining life of the network. This means that remaining asset costs and any capital and operating costs to maintain the network for remaining customers are shared between all existing customers.

Lease Payments

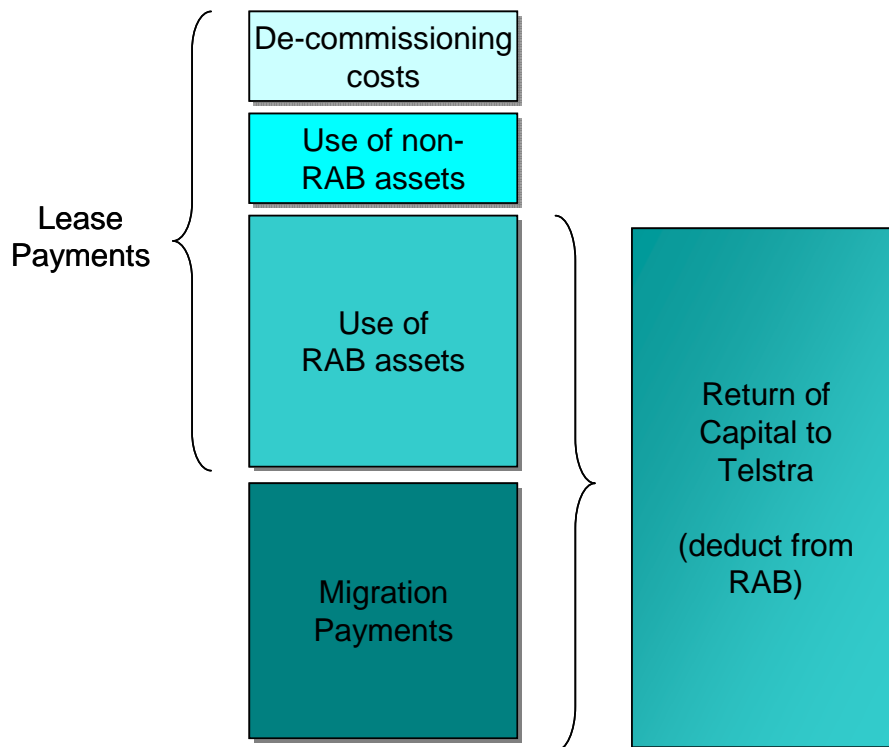
- 5.10 Given the ACCC's characterisation of the lease payments for NBNC Co's use of Telstra infrastructure, Optus submits that these payments have three distinct components, being:
- i) compensation for NBNC Co's use of assets (including ducts and trenches) which now form part of Telstra's RAB for fixed line services (this is likely to be the largest component of the lease payments);
 - ii) compensation for the use of assets (such as inter-city backhaul fibre and exchange buildings) which do not form part of Telstra's RAB for fixed line services; and
 - iii) compensation for de-commissioning expenditure incurred on behalf of NBNC Co. The ACCC has stated that the lease payments "*will include recovery of operating and capital*

expenditures incurred by Telstra before lines are de-commissioned.”⁴⁵

- 5.11 Optus considers that expenditure that is carried out to facilitate de-commissioning should rightly be recovered from NBNC_o and excluded from any costs to be recovered from access seekers. Accordingly these costs should be separately accounted and offset against any relevant payments received from NBNC_o. It follows that de-commissioning payments should not be treated as a return of capital and deducted from the RAB.
- 5.12 Optus considers that it would also not be appropriate to deduct compensation for the use of assets such as inter-city backhaul fibre and exchange buildings from the value of Telstra’s RAB for fixed line services. The reason is that these assets do not form part of Telstra’s RAB for fixed line services. Some of the assets (such as inter-city transmission fibre) may be used to deliver separate regulated services which are not part of the fixed line review (such as the domestic transmission capacity services), and compensation for such assets might be relevant to the pricing of those other regulated services. However, the compensation payments for such assets can currently be set aside.
- 5.13 However, a large constituent component of the lease payments relates to the use by NBNC_o of assets which do form part of Telstra’s RAB(s) for fixed line services. Ducts, trenches and pits form part of the RAB for the CAN. It is also possible (although this is not entirely clear) that some of the lease payments relate to the use by NBNC_o of assets which form part of the RAB for the Core network, such as inter-exchange transmission, and Core network ducts and trenches. Therefore, Optus submits that the ACCC should deduct this latter RAB-related element of the lease payments from the value of the Telstra’s RAB for fixed line services.
- 5.14 Compensation for the use of RAB assets is a distinct component of total compensation to Telstra, which *does* represent a further ‘return of capital’ to shareholders for capital invested in the network. The migration payments represent only a part of the compensation for Telstra no longer being able to provide services using its network; the component of lease payments which relates to the use of RAB assets represents further compensation for the same thing. Seen in this way, dividing the payments between leases and migration is to some extent artificial: both the migration payments and the RAB-related component of the lease payments should be interpreted as compensation to Telstra and its shareholders for their investment. Therefore, both should be viewed as a ‘return of capital’ to Telstra shareholders for capital invested in the RAB.
- 5.15 The breakdown of the various payments by NBNC_o to Telstra is represented in the diagram below.

⁴⁵ ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services – Draft Report, September 2010, pg29.

Figure 5.1 Total NBNCo Payments to Telstra



5.16 Optus contends that if both relevant elements of the payments Telstra will receive from NBNCo are not properly taken into account as a return of capital to Telstra, this will result in a very significant over-recovery. Even before the NBNCo payments are considered, Telstra will receive substantial net cashflows from its fixed network assets over the coming years: it is estimated it will receive a net present value of \$11.7 billion in profits from fixed products over the 2011 to 2014 period alone.⁴⁶ When the \$9 billion NPV of payments from NBNCo is added to this, it becomes clear that Telstra will recover costs far in excess of its network investment.

Depreciation

5.17 The ACCC has proposed to apply a straight line methodology to calculate depreciation, for the following reasons:⁴⁷

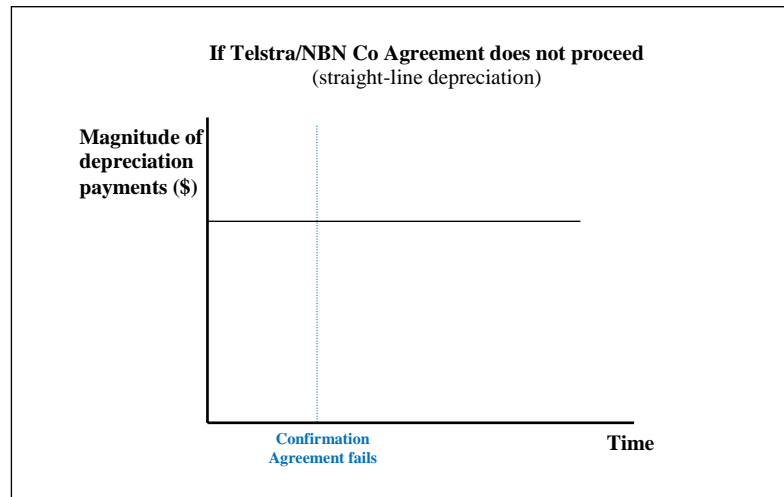
- i) it will allow the access provider to recover the costs of assets over their lives;

⁴⁶ This estimate is consistent with reporting by brokerage firm commercial analysts in September 2010. It has been calculated using information from Telstra's 2010 annual report. Total fixed product revenue has been trended forward using the year-on-year percentage change in each of the fixed product categories. Product profitability is taken into account for PSTN products (59%) and fixed internet (41%) categories. In order to be conservative, no profit margin has been applied to ISDN products and other fixed revenue categories. A discount rate of 10% was applied (consistent with discount rates used by brokerage firm commercial analysts to value Telstra in September 2010).

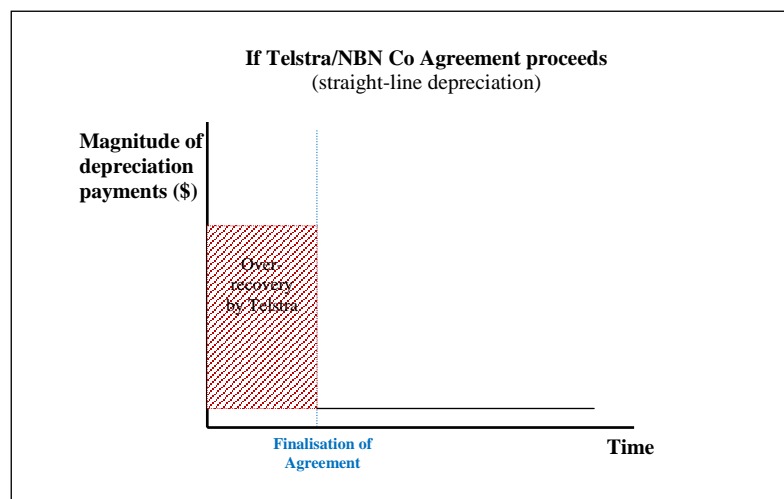
⁴⁷ ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services – Draft Report, September 2010, pp31-32.

- ii) to promote price stability for end users and greater certainty over the regulatory period; and
- iii) it is the most common approach utilised by the ACCC and the AER in regulating other industries as well as being the simplest method to apply.

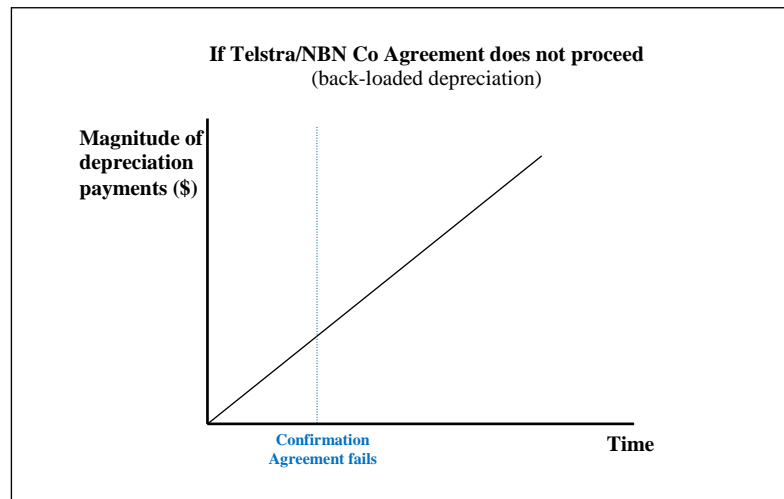
5.18 Optus considers that a straight line methodology would be a reasonable approach, which would not lead to over-recovery – *provided* the Telstra-NBNCo agreement does not proceed.



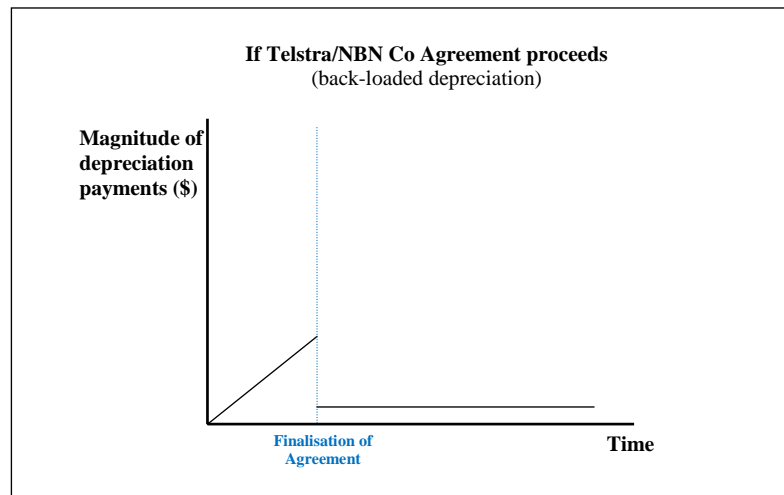
5.19 However, Telstra is likely to receive substantial capital recovery through payments from NBNCo. As discussed above the payments constitute a return to Telstra’s shareholders of the capital they have invested in the fixed network. It follows that, provided Telstra’s agreement with NBNCo proceeds, *any* allowance for depreciation in access charges will over-compensate Telstra for the recovery of capital costs associated with its existing network assets. So if the agreement with NBNCo proceeds, the proposed straight line depreciation profile would cause Telstra to over-recover, as illustrated in the following diagram.



- 5.20 This over-recovery in the period prior to finalisation of the agreement would necessitate an adjustment to the depreciation profile (and a corresponding reduction in access prices) after the agreement is finalised, when the ACCC will be able to take the payments into account. The ACCC must consider the strong possibility that the depreciation element of access charges will need to be substantially reduced (perhaps to zero), in order to prevent overcompensation.
- 5.21 However, there is an element of uncertainty, given the possibility that the NBNC Co agreement may not proceed. In order to deal with this uncertainty, and to minimise the risk of over compensation, Optus submits that the ACCC should initially set an upward sloping depreciation profile, such that recovery is back-loaded. If the agreement with NBNC Co does not proceed, depreciation allowances could simply proceed according to the upward sloping profile.



- 5.22 However, in the likely scenario where the Telstra – NBNC Co agreement does proceed, this approach has the advantage of preventing over-recovery in the initial period (before the agreement is finalised). It also allows for the compensation payments from NBNC Co to be taken into account in future once the FHoA becomes binding, in such a way that the path of access prices is not disturbed.



6. Cost Allocation

- 6.1 The allocation of cost to the ULLS in the BBM is substantially driven by the ACCC's modelling assumption that the unit capital costs for duct and cable assets are equal for all services and uniform across the country. In this section Optus will demonstrate that this assumption is incorrect and distortionary. It introduces a very substantial increase in the price of the ULLS (a 93% increase), and an anticompetitive cross-subsidy from access seekers to Telstra of \$84 million annually.
- 6.2 Optus also wishes to comment on a number of other issues regarding the cost allocation rules applied in the BBM,⁴⁸ including:
- i) the allocation of switching equipment costs within the Core network for PSTN OTA services;
 - ii) potential errors in the application of cost allocation factors in the BBM;
 - iii) the exclusion of the line sharing service from the ambit of the BBM.

The 'equal unit capital cost' assumption

- 6.3 Some of the most important cost allocation factors in the BBM are derived using the ACCC's modelling assumption that the unit capital cost for duct and cable assets is equal for all services. In this section Optus will demonstrate that this assumption creates a significant distortion by failing to take into account the differences in unit costs for ducts and pipes and copper cables across the geographic bands.
- 6.4 The ACCC discusses the equal unit capital cost assumption in a section of the paper dealing with 'de-optimisation' of cost allocation factors it has derived from the Analysys model. It has noted that more fibre was provisioned in the Analysys model than actually exists in the current Telstra network. This lowers unit costs for WLR and other services relative to ULLS, hence "*[o]ptimisation will therefore result in lower cost allocation factors ... in respect of ducts and pipes and copper cables than would be compatible with the actual assets in place.*"⁴⁹
- 6.5 The ACCC has concluded that it is unable to address this issue by reference to the Analysys model, noting that "*the model, however, does not specify where fibre was assumed to be installed or what percentage of fibre was used in the model, ... [yet it was able to conclude] that the amount of fibre assumed in the Analysys model is*

⁴⁸ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.90

⁴⁹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.91

significantly greater than the actual amount of fibre currently used in the CAN."⁵⁰

- 6.6 Optus is perplexed by the above assertion. The Analysys model version 2.2 contains precise information on the percentage of fibre used in the model: it assumes that fibre comprises approximately 24 per cent of total cable metres dimensioned in the CAN network, which contributes to approximately 4 per cent of the total cost allocated to cable assets.⁵¹ The calculation of CAN cost allocations within the Analysys model on a per geotype basis⁵² makes use of information on the fibre and copper network.
- 6.7 Nevertheless, in response to this issue the ACCC has changed its approach to the calculation of cost allocation factors applicable to ducts and pipes and copper cables, and has calculated these as follows:
- "The ACCC has adjusted the Analysys cost allocation factors for ducts and pipes and copper cables to ensure that **the average unit costs for these asset classes are equal for the ULLS, WLR and other services provided using these assets.** To achieve equal unit costs for these services, adjusted cost allocation factors have been derived by calculating the shares of services in operation (SIOs) for ULLS, WLR and other services"*⁵³ [emphasis added]
- 6.8 The assumption that average unit costs for duct and cable assets are equal for the ULLS, WLR and Telstra retail services is incorrect. In particular, it is contrary to the fact that ULLS lines have a significantly lower cost profile compared to Telstra retail lines and resale lines. The ACCC has acknowledged this, noting that the *"average unit costs of ducts and pipes and copper cables may be lower for providing ULLS than for providing WLR and other services."*⁵⁴
- 6.9 The ACCC attempts to address this concern by noting that *"...the expected cost advantage in providing ULLS could be offset, to at least some extent, by the use of lower-cost fibre to provide some WLR and other services (such as Telstra's retail services)."* It concludes that "on balance", the equal unit cost assumption is reasonable.
- 6.10 Optus considers that the discussion of this issue in the draft report significantly understates the magnitude of the problem. Optus has calculated that the distortion resulting from this single incorrect assumption, taking into account Band 2 ULLS lines only, amounts to

⁵⁰ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.89

⁵¹ This has been calculated using information provided in the Analysys model version 2.2, where fibre cable has been represented as a proportion of total cable (copper and fibre) dimensioned in the CAN network.

⁵² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.90

⁵³ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.91

⁵⁴ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.92

an annual cross-subsidy to Telstra of \$84 million. By contrast, Optus estimates that the “offsetting” impact of the use of lower-cost fibre amounts to around \$1.3 million annually. That is, the use of lower-cost fibre to provide some services in no way offsets the distortion introduced by the equal unit cost assumption. The derivation of these figures is set out below and in Appendix B.

Calculation of cost-reflective cost allocation factors

- 6.11 In order to estimate the magnitude of the distortion, Optus first considered the cost relativities between ULLS band prices estimated by the PIE II model as adjusted by the ACCC in setting its previous indicative prices (together with the ACCC’s Band 4 price of \$100 “based on information provided by Telstra”). The PIE II prices and network costs (approximated as price less a \$2.50 specific cost allocation) are set out in the following table, which illustrates the significant cost differences between the four geographic bands:

	Price	Network cost
Band 1	\$ 6.60	\$ 4.10
Band 2	\$ 16.00	\$ 13.50
Band 3	\$ 31.30	\$ 28.80
Band 4	\$ 100.00	\$ 97.50

- 6.12 Optus notes that the ACCC cannot have significant concerns about the validity of the network cost figures derived from the PIE II model, given that it has used them to set ULLS prices:⁵⁵

*“To calculate draft indicative band prices, the ACCC has de-averaged the estimated average ULLS price for each year by applying the existing relativities between prices across Bands 1-3. **The existing price relativities were derived from Telstra’s Pie II model which estimates disaggregated network costs and volumes into the four geographical bands.**” [emphasis added]*

- 6.13 It is important to note that ULLS use is overwhelmingly concentrated in low cost ‘Band 2’ urban areas: 94% of all ULLS lines are in Band 2, compared to **CiC begins CiC ends** of Telstra retail lines. On the other hand, an overall **CiC begins CiC ends** of Telstra retail lines⁵⁶ are located in high cost Band 4 areas, whereas there are practically no ULLS in Band 4.
- 6.14 Optus has estimated revised cost allocation factors for the ULLS, WLR and Telstra retail services which take into account an appropriate unit cost differential using network costs derived from the PIE II model as set out above, weighted for the proportion of lines located in each Band for each of the ULLS, WLR and Telstra retail services.⁵⁷ Optus’ revised cost allocation factors are set out in the

⁵⁵ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp.101-102

⁵⁶ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, Confidential Version, September 2010, p.91

⁵⁷ Calculations carried out by Optus are summarised at Appendix B.

tables below:

<u>ULLS</u>	<u>2009/2010</u>	<u>2010/2011</u>	<u>2011/2012</u>	<u>2012/2013</u>	<u>2013/2014</u>
Ducts and pipes & Copper cables	0.0454	0.0499	0.0524	0.0537	0.0543

<u>WLR</u>	<u>2009/2010</u>	<u>2010/2011</u>	<u>2011/2012</u>	<u>2012/2013</u>	<u>2013/2014</u>
Ducts and pipes & Copper cables	0.1161	0.1126	0.1110	0.1096	0.1085

6.15 When these more cost-reflective cost allocation factors are substituted into the BBM, the result for the (4 year average) Band 2 ULLS price calculated by the BBM, for example, is a 48% reduction to \$8.31 / month. It is clear that the distortion introduced by the equal unit line cost assumption is vast, and that ULLS access seekers and their customers are bearing far more than their fair share of Telstra’s network costs. Taking into account Band 2 ULLS lines only, this amounts to an annual cross-subsidy to Telstra of \$84 million. Conversely, Telstra’s own retail lines bear a far smaller share of cost than is appropriate.

6.16 One readily apparent ‘irrational consequence’ of this allocation error is that the proposed access pricing for the ULLS is higher on average than pricing for the Wholesale Line Rental (WLR) service (for a customer sample distributed across all four bands). Consider, for example, two access seekers, each of which has 4,000 customers. If one Access Seeker takes 1,000 WLR services in each of the four geographic bands, and another Access Seeker takes 1,000 ULLS services in each of the four geographic bands, the total access charges paid by each access seeker are set out in the following table:

	ULLS	WLR
Band 1	6,600	20,000
Band 2	16,000	20,000
Band 3	31,000	20,000
Band 4	100,000	20,000
	153,600	80,000

6.17 This perverse result demonstrates that the model’s cost allocation rules are not properly cost-reflective. The WLR price should properly exceed the ULLS price on average, since the WLR service requires the use of additional asset classes which are not required for ULLS.

Impact of the use of lower-cost fibre

6.18 Optus has investigated the possibility that the distortion introduced by the uniform unit cost assumption could be offset by “*the use of lower-cost fibre to provide some WLR and other services (such as Telstra’s*

retail services)”, as the ACCC has suggested. Optus has made some calculations in order to adjust the above cost allocation factors to reflect the fact that some WLR and Telstra retail services are provided over fibre cables. For the unit cost differential between fibre and copper access lines, Optus has used information from the Analysys model v2.2 to calculate that fibre lines are less costly than copper by an average of \$7.94 per line.⁵⁸ Further, Optus has assumed that 5% of all WLR and Telstra retail services are provided over fibre cables. This is a highly conservative assumption, given that according to the FTTH Council,⁵⁹ less than 1% of all Australian access lines are provided over fibre.

- 6.19 Using this information to adjust the cost allocation factors set out in the tables above, Optus has calculated that in order to take account of “the use of lower-cost fibre to provide some WLR and other services”, Optus’ revised cost allocation factors for ULLS (as set out in the table above) should be increased by approximately 0.0007 and the factors for WLR should be decreased by approximately 0.0003.⁶⁰ Optus’ cost allocation factors, with these revisions, are set out in the tables below:

<u>ULLS</u>	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Ducts and pipes & Copper cables	0.0461	0.0507	0.0532	0.0545	0.0551

<u>WLR</u>	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Ducts and pipes & Copper cables	0.1158	0.1123	0.1106	0.1092	0.1082

- 6.20 As a result of this further adjustment, the (4 year average) Band 2 ULLS price calculated by the BBM increases by \$0.12 / month to \$8.43 / month. On this basis, the cost advantages of the fibre lines used to provide a small proportion of WLR and other services (a difference of \$1.3 million annually) are insufficient to offset the distortion introduced by the uniform unit line cost assumption (a difference of \$84 million annually).
- 6.21 If this error is not corrected, ULLS access seekers will pay far more than their ‘fair share’ of Telstra’s network costs and use of the new building block model to set access prices would perpetuate a substantial anticompetitive cross-subsidy from access seekers to Telstra. The equal unit cost assumption violates the principle that access prices should be linked to actual costs, will cause a significant

⁵⁸ This was determined using demand-weighted unit costs calculated based on information on the number of assets and unit cost information by asset type extracted from the Analysys model v2.2. See Appendix B for details.

⁵⁹ FTTH Council, “Global FTTH: Survey shows continuous growth in first half of 2010,” Press Release, <http://www.ftthcouncil.org/en/newsroom/2010/09/26/global-ftth-survey-shows-continuous-growth-in-first-half-of-2010>

⁶⁰ Calculations carried out by Optus are summarised at Appendix B.

over-recovery by Telstra and is contrary to the legislative objectives of allocative efficiency and the promotion of competition.

- 6.22 Optus submits that the ACCC should abandon its equal unit cost assumption. Instead, it should use the best available information on the relative costs of the different geographic bands (potentially the adjusted PIE II results it is already proposing to use to set deaveraged ULLS prices), and it should also use available information to adjust for the cost advantages of the fibre lines used to provide a small proportion of WLR and other services. Optus proposes that the cost allocation factors it has provided above would be adequate for this purpose.
- 6.23 Alternatively, the ACCC could address this issue at the point when it sets de-averaged ULLS prices. CEG has concluded, in a report to be submitted to the ACCC, that the ACCC's current approach is inconsistent with its stated objectives of setting prices which achieve a present value compensation over the life of the CAN equal to the RAB while reflecting the price relativities between each band of the PIE II model.⁶¹ CEG recommends a method by which the ACCC could achieve its objectives through a revised approach to setting de-averaged ULLS prices. Optus refers the ACCC to CEG's report.

Cost allocation of switching equipment

- 6.24 The ACCC has made a set of adjustments *“for the three classes of switching equipment (local, trunk and other) to ensure that unit costs per minute are not inflated by the loss of traffic on the switching equipment.”*⁶²
- 6.25 Optus considers the ACCC's approach to this issue appears reasonable in deriving the cost allocation to be applied in the base period.⁶³ However it is unclear why the adjustment of the switching cost allocation factors does not take into account changes in service demand forecasts in subsequent years.

Potential errors in the application of cost allocation factors in the BBM model

- 6.26 The ACCC has identified that adjustments were made to several asset categories to be applied in the first period, that is 2009/2010, however for each subsequent period it has noted that *“[t]o ensure that the cost allocation factors continue to reflect service' actual usage of infrastructure, the cost allocation factors should be varied to reflect changes in the pattern of demand.”*⁶⁴ This rationale has not been applied consistently within the BBM model. As a result, Optus

⁶¹ CEG, October 2010, *De-averaging ULLS prices*

⁶² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.92

⁶³ If this is based on the assumption that the adjusted local switching cost allocation factor holds true

⁶⁴ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.94

considers some of the cost allocation factors applied in the BBM model⁶⁵ may be too high.

- 6.27 First, it is evident from the values applied that the cost allocation factors for the CAN network change accordingly with the percentage change in the demand for the relevant service.
- 6.28 Optus notes there has been an error in the cost allocation factor applied to ULLS 'Other assets' for the period 2010/2011, in which the ACCC has mistakenly applied the cost allocation factor for 2011/12 as evidenced in the cost allocation table provided in the Draft Report.⁶⁶ As a result, this artificially inflates the cost allocations applied in each subsequent year, hence resulting in a higher nominal service price for ULLS in each period.
- 6.29 Second, it is evident from the values applied that the cost allocation factors for the Core network change accordingly with the percentage change in the demand for the relevant service. The notable exceptions include the treatment of cost allocations applied to the switching and transmission asset categories within the BBM model, including:
- i) There has been no change applied to the cost allocation for local switching for WLR services across the four modelled years.
 - ii) The percentage change in the cost allocation for each of the switching categories for PSTN OTA services remains constant across the four modelled years.
 - iii) The percentage change in the cost allocation for the transmission asset category for PSTN OTA services does not appear to be consistent with the demand adjustment approach considered
 - iv) The percentage change in the cost allocation factors for LCS services are largely consistent with the demand adjustment approach considered, however some discrepancies may be observed due to rounding effects.
- 6.30 These inconsistencies may affect the model in several ways. In particular the resulting service price for each of the declared services using Core network elements.
- 6.31 Since the cost allocation factor for local switching for WLR services does not change over the four modelled years, this indicates that changes in demand have not been taken into account. This potentially results in an over recovery of local switching costs in WLR.
- 6.32 The PSTN OTA switching cost allocations decline by approximately **CiC begins CiC ends** across all switching asset classes in each period. The basis of this percentage value is not immediately

⁶⁵ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.95

⁶⁶ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.95

transparent. Similarly the PSTN OTA transmission cost allocations decline in each period, however this decline in absolute value is not immediately clear.

The Line Sharing Service

- 6.33 Optus notes that the ACCC has decided to exclude the line sharing service (LSS) from the ambit of the BBM, and stated that it will estimate prices for the LSS using a model specific to providing those services.⁶⁷ This means that the LSS access charge will not make any contribution to the common costs of the infrastructure over which the service is carried (the copper loop).
- 6.34 Optus disagrees with this exception for LSS, and considers that it represents an unnecessary distortion which can only impair economic efficiency. As noted in Optus' submission in response to the Discussion Paper,⁶⁸ the ACCC is on record as being in agreement with this principle.⁶⁹ Optus submits that the ACCC should consider the scope for rebalancing between the LSS price and the prices of other network services, such as wholesale line rental.

⁶⁷ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.17

⁶⁸ Optus submission to Discussion Paper, *Access Pricing Principles for Fixed Line Services*, p.43

⁶⁹ ACCC, *Access Dispute between Chime-Telstra – Line Sharing Service (LSS)*, Final Determination and Associated Statement of Reasons, 12 July 2007, p.1

7. Forecast Demand

- 7.1 The BBM requires demand forecasts for various fixed line services including ULLS, WLR, PSTN OTA and Local Call Services.
- 7.2 The ACCC stated in the draft report that it has not been able to obtain forecast data from Telstra. In the absence of Telstra's data, the ACCC has derived its own forecasts based on recent trends in demand for each service and demand forecasts in the Analysys cost model.
- 7.3 Optus notes that it is not clear why Telstra would be unable to produce forecast demand data to the ACCC, given that Telstra would need the information for its internal budgeting purposes.
- 7.4 Further, Optus considers that:
- i) the forecast growth in ULLS SIOs appears low; and
 - ii) the forecast decline in demand for PSTN OTA services assumed in the model may be too rapid.
- 7.5 Optus' comments in response to the ACCC's forecast demand for each of the declared service are outlined below.

ULLS

- 7.6 The 2009-10 ULLS number was sourced from Telstra's CAN RKR.⁷⁰ Optus considers that the use of this data source is reasonable as Telstra's CAN RKR reports the actual demand.
- 7.7 The ACCC has projected a 10% increase in the number of ULLS lines in the first year, followed by 5%, 2.5% and 1%.⁷¹ The ACCC states that the recent substantial growth of ULLS is not expected to continue due to uncertainty around future industry development and possible legislative change.⁷²
- 7.8 Optus notes that the ACCC's forecast growth is low when compared to **CiC begins CiC ends**
- 7.9 As the ACCC is aware, its forecast is low when compared to historical growth. The table below shows that there has been a 33% increase in total ULLS SIOs from June 2008 to June 2009, followed by a 20% increase from June 2009 to 30 June 2010.

⁷⁰ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁷¹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁷² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

Table: Total no. of ULLS lines in June 08, 09 and 10⁷³

ULLS Band	30-Jun-10	30-Jun-09	30-Jun-08	% difference yoy	% difference yoy
1	35,061	29,873	26,346	17	13
2	780,459	652,974	488,511	20	34
3	11,689	9,006	5,636	30	60
4	124	144	99	-14	45
Total	827,333	691,997	520,592	20	33

- 7.10 Similarly, there has been a 45% increase in the total number of ULLS SIOs from March 2008 to March 2009, followed by a 19% increase from March 2009 to March 2010.

Table: Total no. of ULLS lines in March 08, 09 and 10⁷⁴

ULLS Band	31-Mar-10	31-Mar-09	31-Mar-08	% difference yoy	% difference yoy
1	33,414	28,993	24,734	15	17
2	752,535	610,608	418,365	23	46
3	10,872	8,407	4,626	29	82
4	154	139	90	11	54
Total	769,975	648,147	447,455	19	45

Source:

- 7.11 The ACCC's assumption that recent high levels of growth in ULLS will not continue is open to question. The stated reason for the assumption is uncertainty around future industry developments. However, there has been uncertainty around future industry developments for some years now, yet this has not prevented significant growth in ULLS. For example, in 2007 there was speculation that the G9, Telstra or other parties would build a FTTN network.⁷⁵ On 7 April 2009, the Government announced that it would establish a new company to build and operate a new high speed national broadband network.⁷⁶
- 7.12 Further, as acknowledged by the ACCC in the draft report, the increase in ULLS demand can be met by unused slots on DSLAMs.

WLR

- 7.13 The 2008-09 WLR number was sourced from Telstra's 2009-10 annual report.⁷⁷ Optus submits that the source of the report is reasonable as it is based on actual usage.

⁷³ ACCC Snapshot of Telstra's customer access network as at 30 June 2010, 30 June 2009 and 30 June 2008

⁷⁴ ACCC Snapshot of Telstra's customer access network as at 31 March 2010, 30 March 2009 and 30 March 2008

⁷⁵ http://www.minister.dbcde.gov.au/media/media_releases/2007/002

⁷⁶ http://www.minister.dbcde.gov.au/media/media_releases/2009/022

⁷⁷ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

- 7.14 The ACCC forecasts a 3% decrease in 2010-11 followed by a 1.5% decrease in 2011-12, 1.25% decrease in 2012-13 and 1% decrease in 2013-14.⁷⁸ The ACCC considers that one of the factors driving the increase in ULLS and decrease in WLR has been the rate of substitution between the two services.⁷⁹ The ACCC expects that the recent conversion from WLR lines to ULLS is likely to slow over the estimation period as carriers will be less likely to invest in their own infrastructure. Nevertheless, the increase in ULLS demand can be met by the availability of unused slots on DSLAMs.⁸⁰
- 7.15 Optus observes that the forecast is fairly consistent with the actual trend ie a 2.5% decrease in FY 09 to FY 10. It is possible that WLR services will see additional growth in the coming years, particularly in light of the imminent construction of the NBN and possible declaration of the wholesale DSL service.
- 7.16 With the imminent construction of the NBN, access seekers may seek to build market share in regional areas by accelerating their percentage of WLR services.
- 7.17 There is also the prospect of wholesale DSL prices to be reduced in the future. The ACCC on 20 October 2010 issued an open letter to the industry, stating that it may commence an inquiry to declare the wholesale ADSL service.⁸¹ Should the ACCC declare the wholesale ADSL service and set a competitive regulated price for the service, there may be a strong increase in demand for Telstra's resale services in the coming years.
- 7.18 Optus considers that a conservative estimate would be to adopt a constant profile for WLR, ie apply the 2008-09 number for the remainder of the regulatory period.

PSTN OTA

- 7.19 The ACCC has calculated the 2008-09 PSTN OTA number based on Telstra's RAF.⁸² Optus considers that the source is reasonable as it is based on actual demand.
- 7.20 The ACCC has forecast a 10% decline in 2010-11 followed by a constant decline of 8% for the remainder of the period.⁸³ The ACCC considers the demand for PSTN OTA is expected to reflect the rate of substitution from fixed to mobile voice services.

⁷⁸ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁷⁹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁸⁰ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁸¹ ACCC, *Open letter re proposed wholesale ADSL inquiry*, 20 October 2010

⁸² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁸³ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

- 7.21 The ACCC's assumed forecast decline for PSTN OTA may be too steep. As mentioned elsewhere it is likely that access seekers will attempt to acquire market share in areas where they do not have DSLAM coverage via Telstra's resale service. It follows that the demand for PSTN OTA will also increase.

CiC

- 7.22 In addition, it is likely that fixed to mobile minutes for preselect will likely increase in the coming years. **CiC begins CiC ends**
- 7.23 Accordingly Optus proposes the ACCC adopt a conservative estimate by using a constant profile, ie apply the 2008-09 number for the rest of the regulatory period.
- 7.24 Further, we note that Telstra has indicated that it has a number of marketing initiatives in hand to try to slow the reduction in its key revenue lines, such as fixed voice calls. The likelihood that Telstra will increasingly embrace capped plans is likely to drive traffic growth.

LCS

- 7.25 The 2008-09 estimate was calculated by summing up the local calls listed in the RAF data from various services providers, augmented by an estimated allowance for calls carried by carriers not required to submit the RAF.⁸⁴
- 7.26 However, the use of RAF data from various service providers may not be appropriate considering not all carriers are required to file a RAF report to the ACCC. Whilst the ACCC stated that it has included an estimated allowance, it is not transparent what the allowed estimates are.
- 7.27 The ACCC assumed a 10% decline in the first year, followed by an 8% decline in the remainder of the period for LCS.⁸⁵ Optus does not concur with the ACCC's assumed trend as the decline may be too rapid. As mentioned elsewhere it is likely that access seekers will try to acquire market share in areas where they don't have DSLAM coverage via Telstra's resale service. It therefore follows that demand for LCS will increase.
- 7.28 Optus submits that the ACCC should adopt a conservative estimate by using a constant profile, ie apply the 2008-09 number for the rest of the regulatory period.

⁸⁴ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

⁸⁵ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp96-97

8. Structure of Prices

ULLS

- 8.1 The ACCC has proposed to set de-averaged prices for the ULLS, keeping the current four band structure. In support of its decision it has noted the fact that the ULLS is not technically viable for delivering high speed data services in rural areas. It has also noted the risk of inefficient bypass in urban areas and expressed the view that nationally averaged prices would distort allocative efficiency since they are not cost-reflective.
- 8.2 Optus supports the ACCC's decision to set ULLS prices on a de-averaged basis, and agrees with the reasons set out by the ACCC in its draft decision, which have been supported by the Australian Competition Tribunal in its 2007 decision to reject Telstra's ULLS undertaking.⁸⁶
- 8.3 The ACCC's proposed approach will support business certainty in the industry, particularly for access seeker investors such as Optus, which have made substantial investments in DSLAM infrastructure in Band 2 in reliance on de-averaged ULLS pricing. The continuation of the four band approach will encourage efficient investment in infrastructure.
- 8.4 The ACCC has also sought industry comment on whether a two-stage transition period may be appropriate, whereby a nationally disaggregated four band ULLS pricing structure would remain until the end of 2014, after which the Commission would reassess the appropriateness of disaggregated ULLS prices.
- 8.5 This proposal is without merit. It appears that the ACCC's concern might be driven more by political considerations regarding the transition from a de-averaged ULLS price to an averaged NBN price. The ACCC should set those concerns aside:
- Under the proposed terms of the Telstra/NBNCo deal and the Competition and Consumer Safeguards Bill, this migration will proceed (and will not be prevented by a price differential); and
 - To set an averaged price could deliver Telstra a windfall gain on all metropolitan lines – such a result simply cannot be justified on any sensible grounds.

⁸⁶ The Tribunal reaffirmed that geographic averaging is inappropriate having regard to s152AB and s152AH of the Act. The Tribunal found that geographic averaging is not in the long term interests of end users. It identified many negative effects of geographic averaging. In respect of urban areas (Band 1 and 2) for example, the Tribunal considered that geographic averaging has the potential for encouraging “inefficient bypass of Telstra's CAN” and “inefficiently low levels of infrastructure investment by access seekers...” *Re Telstra Corporation Ltd (No 3)* [2007] ACompT3, para 167

PSTN OTA

- 8.6 The ACCC has proposed to set de-averaged prices for PSTN OTA, keeping the current structure.
- 8.7 Optus has a number of concerns with the proposed rate table for PSTN originating and terminating access (PSTN OTA) charges, which were set out in its letter to the ACCC of 29 September 2010.
- 8.8 The price table proposed by the ACCC provides for a flagfall and conveyance cost for each of four different geographic bands. The weighted average headline rate a carrier pays reflects its specific traffic split across the geographic bands and its average call hold-time (this converts the flagfall to a cent/minute rate). Optus notes that the basic format of the price table was adopted by the ACCC in its final model prices determination of October 2003 and was based on the construct put forward by Telstra from its PIE II model.
- 8.9 Optus' concern is that traffic patterns have changed since this rate table was developed and consequently the table will not deliver the outcome anticipated. That is, application of this rate table on an industry wide basis is likely to result in Telstra recouping more than the headline average PSTN OTA rate of 1.1 cent/minute for Telstra.
- 8.10 As noted in the letter, there are two factors which have caused a significant change to traffic patters in the seven years since the rate construct was developed in 2003:
- i) A significant growth in the take-up of mobile services, and
 - ii) A significant take-up in ULLS since 2006.
- 8.11 Evidence in support of these two factors is set out below.

Growth in mobile

- 8.12 There has been a significant growth in the take up of mobile services since 2003. Mobile penetration has grown from 14.3 m in 2003 to 26.7 m in 2010.
- 8.13 Optus submits that the significant growth in the take-up of mobile services will drive a significant increase in the volume of mobile to fixed traffic (M2F) terminating on Telstra's network. This is evident from the increase in the number of Optus' M2F minutes terminated on Telstra's network from 2006 to 2010. Optus refers the ACCC to the table below. **CiC begins**

CiC ends

- 8.14 Optus further submits that the ACCC's assumption of 4 minutes per call is unreasonable considering calls from mobile handsets tend to be of a shorter duration than calls from a fixed handset. **CiC begins**

CiC ends

Significant take-up in ULLS

- 8.15 In 2003 there were a handful of ULLS SIOs. However, by 2010, it is estimated that there are over 800,000 ULLS SIOs.⁸⁷

Impact

- 8.16 With these changes in traffic patterns, application of the ACCC's proposed rate table will result in higher revenue per minute for Telstra than is anticipated. This is demonstrated in the following table, which shows the application of the current rate table based on a lower call hold time (scenario 1); a different geographic traffic mix (scenario 2); and combination of each of these changes (scenario 3).

	Traffic %				Call Hold Time (mins)	Headline Rate
	CBD	Metropolitan	Provincial	Rural		
ACCC profile	5%	75%	13%	8%	4.00	1.10
Scenario 1	5%	75%	13%	8%	3.00	1.19
Scenario 2	4%	66%	18%	12%	4.00	1.27
Scenario 3	4%	66%	18%	12%	3.00	1.36

Begin Commercial-in-confidence section

End commercial-in-confidence section

Next steps

- 8.17 Optus strongly encourages the ACCC to amend its current proposed rate table to take account of the changes in traffic patterns noted in this letter. Such an approach would help to mitigate the risk of cost over recovery by Telstra.
- 8.18 However, given the dynamic nature of our industry any rate table adopted by the ACCC is at risk of becoming quickly outdated. An alternate approach for the ACCC would be to dispense with the arcane rate table and move to a single national average rate PSTN OTA rate, consistent with the approach adopted for MTAS and WLR/LCS pricing. This approach would have the advantage of ensuring that Telstra recoups its target cost of 1.1 cent for every minute of originating/terminating PSTN traffic.
- 8.19 The ACCC has typically stated a preference for de-averaged pricing where cost differences across regions are large. However, for the PSTN OTA services, the cost differences between regions are unlikely to be large, since the cost of local loop infrastructure is not

⁸⁷ ACCC, Snapshot of Telstra's customer access network as at 30 June 2010

attributable to these services. Further, the risk of 'inefficient bypass' which is a relevant factor against ULLS averaging does not apply for PSTN OTA pricing, since it is not possible to 'bypass' PSTN terminating access (and it is not likely that a PSTN OA access seeker would build bypass infrastructure). In contrast to ULLS, deaveraging of PSTN OTA in the manner proposed will actually create a substantial risk of over-recovery of costs by Telstra.

- 8.20 It follows that averaged pricing would be appropriate for the PSTN OTA service.

9. Draft Indicative Prices

- 9.1 Optus considers that the indicative access prices for wholesale services must be clearly linked to the costs calculated by the ACCC's building block model. This is not the case, however, for the current proposed indicative prices, some of which bear little relation to model outputs and have been 'marked up' by substantial amounts for reasons that remain unexplained.
- 9.2 This feature of the ACCC's draft report is of great concern. It is difficult to understand how the objectives of the access pricing reforms can be achieved if prices are not set according to the ACCC's pricing principles. These discrepancies will result in substantial over-recovery by Telstra: the markup to the Band 2 ULLS price alone causes an annual over-recovery of over \$9 million per year and the markup to the WLR price is even more substantial.

Discrepancies between modelled prices and indicative prices

Calculation of ULLS band prices

- 9.3 The de-averaging approach used to set ULLS band prices is not contained within the BBM, which simply lists average service prices for each of the four years of the regulatory period. However, the ACCC has made statements about the de-averaging approach used to set ULLS band prices on its website, and set out calculations for setting the price in each band.⁸⁸ For example: *Band 2 price = existing Band 2 price/ existing demand-weighted average price X draft average price*
- 9.4 The ACCC has also noted that “[a]ll prices have been smoothed to be uniform from 1 January 2011 to the end of 2014. The ACCC considers that smoothing prices to obtain a single draft indicative price for each service over the regulatory period provides certainty and stability.”⁸⁹ Optus notes that the simplest way to obtain a smoothed approach is to apply a simple 4 year average price for the 4 years of the regulatory period.
- 9.5 If ULLS prices were calculated and smoothed according to the approach outlined by the ACCC, this would result in an average ULLS price of **CiC begins CiC ends** or equivalently, geographically de-aggregated prices of **CiC begins CiC ends** for Bands 1, 2 and 3 respectively. These figures are simple 4 year averages, as set out in the following table:⁹⁰ **CiC begins**

⁸⁸ ACCC, *Fixed line service pricing review draft report – Questions and answers*, <http://www.accc.gov.au/content/index.phtml/itemId/951666>

⁸⁹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.55

⁹⁰ In deriving these values, Optus has calculated the existing demand-weighted average price to be \$15.82 using ULLS SIO information provided in the ACCC, *Snapshot of Telstra's Customer Access Network as at June 2010*.

CiC ends

- 9.6 However, it appears from the results set out in the above table that the proposed Band 2 indicative ULLS price has been set at a level **c-i-c c-i-c** higher than the four year average cost calculated by the model for Band 2 ULLS lines. These discrepancies are not explained in either the draft report or the ACCC website.

Calculation of WLR price

- 9.7 In its draft pricing principles, the ACCC has set out in Schedule 1 that the price of the WLR “*should be determined on the basis of a building block model.*”⁹¹ The nominal service prices for WLR based on BBM outputs are set out in the table below:

CiC begins

CiC ends

- 9.8 It appears from the results set out in the above table that the proposed indicative WLR price has been at a level **c-i-c c-i-c** higher than the four year average cost calculated by the model. It is not immediately clear how the ACCC has arrived at its nationally averaged⁹² draft indicative price of \$20 for WLR.

Optus' comments

- 9.9 It appears from the results set out in the above tables that certain key indicative prices, particularly the proposed indicative prices for Band 2 ULLS and WLR, have been inflated substantially above their respective 4 year averages. These discrepancies are not explained either in the draft report or on the ACCC website.
- 9.10 One possible inference is that the indicative prices for each band have not in fact been set according to the methods set out by the ACCC. An alternative inference is that the calculations have been performed in the manner indicated and subsequently a significant adjustment has been made for reasons that remain unexplained. Perhaps the ACCC has been guided by an over-riding objective to achieve price continuity. Certainly it is somewhat surprising that the ACCC's new approach has led to a significant devaluation of the Telstra CAN, yet the price of the most critical access service, the metropolitan Unconditioned Local Loop Service (ULLS), has remained stable.
- 9.11 If indicative prices have been set in order to achieve a result which has been predetermined by political considerations, Optus considers

The draft average price considered for each period is based on the nominal service price (per month) for ULLS calculated in the BBM model.

⁹¹ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.129

⁹² ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.53

that this would be a serious error. This possibility raises important questions. Where is the benefit from reviewing access pricing principles if prices are in reality determined by some unknown factor independent of those pricing principles? How does such a practise deliver transparency and regulatory certainty? How is competition promoted if access prices are arbitrarily marked up? How are any of the legislative criteria advanced by allowing over-recovery of over \$36 million by Telstra over the four year period (for Band 2 ULLS alone)? The ACCC's proposed approach risks defeating the purpose of its intended reform.

- 9.12 Prices based firmly on the results of the ACCC's principles and its model will be robust and less prone to the risk of legal challenges. Optus submits that in order for the proposed new pricing principles to achieve the ACCC's competition and investment objectives and prevent over-recovery by Telstra, those principles must actually be applied, and access prices must be set based on the results of the ACCC's model.

Appendix A: Equipment Prices

- 9.13 The following are examples of equipment for which prices have fallen over the years. They relate mainly to IP routers and fibre cables.

IP routers

- 9.14 Prices for some IP routers have decreased by **CiC CiC** from 2006 to 2010. In 2006, the price for a M320 router was **CiC CiC** and in 2010, the price for an equally loaded router MX 960 would cost **CiC CiC**.
- 9.15 Although the two routers are of different models, their port configurations are the same. This is due to advance in technology moving forward.
- 9.16 The M320 router price was extracted from the **CiC CiC** whilst the MX 960 router was actual tender price put forward by Vendor, **CiC CiC**.
- 9.17 There are also other types of IP routers which prices have fallen. This is illustrated in the table below.

CiC begins

CiC ends

Inter-exchange cables

- 9.18 Prices for fibre cables in general have fallen also. For some type of cable, the price has fallen by **CiC CiC** from 2009 to 2010. The table below shows the type of cables which Optus mostly used, either for its HFC, transmission and/or mobile network and the price trend over the year 2009 to 2010.
- 9.19 These prices are actual prices offered by vendors **CiC begins CiC ends**.

CiC begins

CiC ends

Appendix B: Cost Allocation Calculations

- 9.20 This appendix sets out the calculations used to determine Optus' cost allocation adjustments, as discussed in section 6 of this submission.

Calculation of cost-reflective cost allocation factors

- 9.21 In order to estimate the magnitude of the distortion, Optus first considered the cost relativities between ULLS band prices estimated by the PIE II model as adjusted by the ACCC in setting its previous indicative prices (together with the ACCC's Band 4 price of \$100 "based on information provided by Telstra"). The PIE II prices and network costs (approximated as price less a \$2.50 specific cost allocation) are set out in the following table, which illustrates the significant cost differences between the four geographic bands:

	Price	Network cost
Band 1	\$ 6.60	\$ 4.10
Band 2	\$ 16.00	\$ 13.50
Band 3	\$ 31.30	\$ 28.80
Band 4	\$ 100.00	\$ 97.50

- 9.22 Taking into account ULLS use is concentrated in low cost 'Band 2' urban areas, Optus has estimated revised cost allocation factors for the ULLS, WLR and Telstra retail services which take into account an appropriate unit cost differential using network costs derived from the PIE II model as set out above, weighted for the proportion of lines located in each Band for each of the ULLS, WLR and Telstra retail services.
- 9.23 This adjustment can be described as a three step process. Firstly, using information set out in the table below⁹³ and applied to a total customer base of 10 million customers (where the value of this customer base is for illustrative purposes) to determine the respective number of customers representative in each band and for each of the three service categories.

CiC begins

CiC ends

- 9.24 Second, a total cost for each service category is calculated by multiplying the number of SIOs by the network cost, which is uniformly applied to each service category on a per band basis. Optus considers it is appropriate to apply the same cost differential across all services given all ULLS, WLR and Telstra retail services commonly use the assets described within the ducts and pipes, and copper cables asset categories.
- 9.25 Finally, the total cost for each service category is then aggregated and represented as a percentage of the total cost across all services. This value is then applied as the initial cost allocation factor for the base year.

⁹³ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, p.91

Optus' revised cost allocation factors are set out in the tables below:

<u>ULLS</u>	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Ducts and pipes & Copper cables	0.0454	0.0499	0.0524	0.0537	0.0543

<u>WLR</u>	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Ducts and pipes & Copper cables	0.1161	0.1126	0.1110	0.1096	0.1085

- 9.26 When these cost allocation factors are substituted into the BBM, the result for the (4 year average) Band 2 ULLS price calculated by the BBM, for example, is a 48% reduction to \$8.31 / month.

Impact of the use of lower-cost fibre

- 9.27 Optus has investigated the possibility that the distortion introduced by the uniform unit cost assumption could be offset by “*the use of lower-cost fibre to provide some WLR and other services (such as Telstra’s retail services)*”, as the ACCC has suggested. Optus has made calculations in order to adjust the above cost allocation factors to reflect the fact that some WLR and Telstra retail services are provided over fibre cables.
- 9.28 For the unit cost differential between fibre and copper access lines, Optus has used information from the Analysys model v2.2 to calculate that fibre lines are less costly than copper by an average of \$7.94 per line. This value has been calculated by first extracting the information on the number of assets, by asset type, as dimensioned in copper and fibre networks from the Analysys model v2.2. The relevant asset types are outlined in the table below.

Copper network		Fibre network
lead-in: 2	copper dist: 100	NTP>>next node
lead-in: 10	copper main: 400	link on fibre rings
lead-in: 30		pillar>>LE
lead-in: 50		LPGS>>LE

- 9.29 The unit price for each of the identified assets was extracted from the ‘TA.Access’ worksheet in the Cost module. A demand-weighted unit cost was calculated for both the copper and fibre networks, based on the number of assets dimensioned in the model. The cost differential is the difference between the demand-weighted copper and fibre unit costs.
- 9.30 To calculate the impact of the cost differential, it is assumed that 5% of all WLR and Telstra retail services are provided over fibre cables. This is

a conservative assumption, given that according to the FTTH Council,⁹⁴ less than 1% of all Australian access lines are provided over fibre.

- 9.31 It follows that the remaining 95% of the total WLR and Telstra retail SIOs in each band has been assumed to be serviced by copper. As such, the WLR and Telstra retail network costs are revised to take into account the fibre assumption. To do this, 95% of the total WLR and Telstra retail SIOs are subject to the same network costs as ULLS SIOs, while the remaining 5% are subject to a new network unit cost (based on the original derived network cost minus the average demand-weighted cost differential between copper and fibre). These resulting network costs for WLR and Telstra retail SIOs, respectively, are then represented as a percentage of the total cost across all services. This value is then applied as the initial cost allocation factor for the base year. Optus' revised cost allocation factors, with these revisions, are set out in the tables below:

<u>ULLS</u>	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Ducts and pipes & Copper cables	0.0461	0.0507	0.0532	0.0545	0.0551

<u>WLR</u>	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014
Ducts and pipes & Copper cables	0.1158	0.1123	0.1106	0.1092	0.1082

- 9.32 As a result of this further adjustment, the (4 year average) Band 2 ULLS price calculated by the BBM increases by \$0.12 / month to \$8.43 / month.

⁹⁴ FTTH Council, "Global FTTH: Survey shows continuous growth in first half of 2010," Press Release, <http://www.ftthcouncil.org/en/newsroom/2010/09/26/global-ftth-survey-shows-continuous-growth-in-first-half-of-2010>

Appendix C: Connection Charges

- 9.33 This appendix contains comments on the setting of ULLS connection charges, in particular the charges set for the base year period.
- 9.34 The ACCC has applied the existing suite of ULLS charges as its base year price, as originally set out in the 2008 ULLS principles. These charges were subsequently rolled over to 31 December 2010 on the basis:
- “The roll over of pricing principles and indicative prices is intended to be an interim measure to ... provide industry with a greater level of certainty in the short to medium term until the final outcome of the proposed legislative changes are known.”⁹⁵*
- 9.35 However there appears to be an error in the ACCC’s indicative prices, where an incorrect value has been set for the base year period in the ACCC’s ‘Charges for ULLS managed network migration – involving the transfer of end user data services from a Telstra wholesale PSTN and/or ADSL service, or from a line that Telstra is using to supply a ULLS to another access seeker (‘MNM’).’ As a result, the pricing table⁹⁶ represents values that are greater than it should be in each period, using the approach stated.
- 9.36 Corrected for this error, the value in the base year should instead be \$138.00, in accordance to the indicative price set out in the 2009 pricing principles.⁹⁷

⁹⁵ ACCC, *Pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS – 1 August 2009 to 31 December 2010*, Final decision, December 2009, p.19

⁹⁶ ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft Report, September 2010, pp106 and 127

⁹⁷ ACCC, *Pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS – 1 August 2009 to 31 December 2010*, Final decision, December 2009, p.140