

Comment on the ACCC  
further draft decision in  
relation to fixed line  
services

Report for Gilbert + Tobin

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## **1. Introduction**

### **1.1 Scope**

1. I have been engaged by Gilbert + Tobin, on behalf of Telstra, to comment on the ACCC's further draft decision<sup>1</sup> on Telstra's regulated prices for fixed line services in relation to the ACCC's treatment of the impact of the National Broadband Network. I have also been asked to respond to the advice the ACCC received from Analysys Mason in relation to this issue.<sup>2</sup>
2. I have previously provided three reports during the current review of the ACCC on the same or related issues.

### **1.2 Authorship**

3. This report has been prepared by Jeffrey John Balchin, Managing Director of Incenta Economic Consulting. I have 20 years experience in relation to economic regulation across a range of infrastructure sectors, which has included advising regulators, governments, asset owners and major customers. This has included many years of experience with the design and implementation of the "building block" model of regulation in Australia and New Zealand. My curriculum vitae was attached to an earlier report I provided on this matter.<sup>3</sup>
4. I have been assisted in preparing this report by Scott Stacey; however, I take responsibility for all of the report's contents.
5. I have read, understood and complied with the Federal Court's guidelines for expert witnesses, which are appended to this report as Appendix A.

### **1.3 Overview of the ACCC's Further Draft Decision**

6. The ACCC has decided to separate its treatment of assets whose use is expected to be affected by the NBN into two classes, namely:
  - a. assets that will become individually redundant when customers migrate to the NBN – these will be treated as a disposal, and removed from the regulatory asset base, and
  - b. assets that will continue to be used but will be used to a lesser extent as customers migrate to the NBN, in which case the ACCC will modify "the cost allocation factors

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<sup>1</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June.

<sup>2</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra's cost allocation framework, June.

<sup>3</sup> Incenta Economic Consulting (2014), Cost allocation for fixed line services, October.

to ensure that the increased unit costs associated with this under-utilisation will not be allocated to fixed line services”.<sup>4</sup>

7. In relation to this latter adjustment, the ACCC stated that it proposes to:<sup>5</sup>
  - a. *Step 1*: estimate the unit costs for each asset class that would result in the hypothetical world where there was no NBN
  - b. *Step 2*: compare the unit costs calculated in the hypothetical world with the unit costs that are implied by the forecasts of actual costs and demand, and calculate the proportion by which the hypothetical (no-NBN) unit costs are lower than the unit costs calculated for actual costs and demand), and, and
  - c. *Step 3*: scale down the cost allocation factors for each asset class by the proportion by which the hypothetical unit costs are lower than actual unit costs (as calculated in step 2). This scaling down of the cost allocation factors means that the cost that is allocated to – and thereby recoverable from – the access services is reduced by the proportion calculated in step 2.
8. Notably, this scaling down of cost recovery now extends also to costs in relation to data equipment (which in the draft decision the ACCC indicated would be inconsistent with its statutory obligations),<sup>6</sup> and operating expenditure (that is, ongoing expenditure).
9. The ACCC’s reason for these adjustments is its view that:<sup>7</sup>

*The ACCC considers that remaining users of the fixed line network during the transition to the NBN should not bear costs they do not cause and which are associated with assets they will not use.*

10. The ACCC also stated that treating assets in this way was consistent with the Fixed Principles.<sup>8</sup>

## 1.4 Overview of response

11. The ACCC’s further draft decision is not consistent with the Fixed Principles and it is not consistent with promoting the long term interests of end users (LTIE).

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<sup>4</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.73.

<sup>5</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, pp 73-74.

<sup>6</sup> ACCC, Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision’, March 2015, pp. 139-140.

<sup>7</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.71.

<sup>8</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.74. The Fixed Principles are set out in ACCC (2011), Final Access Determinations, June, clause 6.

12. In relation to the *assets that are to be progressively underutilised*, the ACCC's further draft decision is, in effect, a return to the "partial cost allocation approach" that I commented upon extensively in my first report,<sup>9</sup> notwithstanding the ACCC's subsequent position that it intends to implement a fully distributed cost method. I say this because step 3 in the ACCC's method as described in paragraph 7 above means that the ACCC commences with cost allocation factors resulting from applying a fully distributed cost method, but then scales down those allocators to reflect its view that a network in a hypothetical world (i.e., without the NBN) would have a lower unit cost. This scaling down step – and application of hypothetical inputs – is simply not done when applying the cost allocation step when applying the building block approach. Accordingly, my key complaints about the "partial cost allocation" approach apply equally to the method the ACCC has said it now intends to apply, namely that there is no reason to expect a stream of revenue to match those costs – part of the revenue requirement simply disappears into a black hole. As I explained in that earlier report, such a cost allocation method:
- a. is not a valid application of the building block approach, which is mandated by the Fixed Principles, because the building block approach requires there to be a reasonable opportunity to recover efficiently incurred costs<sup>10</sup>
  - b. does not comply with the specific principle for cost allocation in the Fixed Principles (I show in this report that the ACCC's reasoning is perverse and results in costs being allocated to non-usage rather than usage and based on cost-relief rather than cost causation)
  - c. does not comply with the specific Fixed Principle for demand forecasts which requires that the best forecast of the actual sales of the fixed line services over the regulatory period ahead by used, and
  - d. will create an environment that is antithetical to investment and Telstra's legitimate commercial interests, and so to not promote the LTIE.
13. In relation to *assets that will be individually redundant*, I remain of the view expressed in my last report that an essential requirement for a disposal is that there is a transaction in relation to the asset and so the ACCC's proposed adjustment is not authorised by the Fixed Principles. While I am not an expert in accounting principles, I observe that the clear wording in the relevant accounting standard (which the ACCC has invoked) supports my conclusions in this regard rather than the ACCC's.
14. It is not clear from the further draft decision why the ACCC considers there to be a pressing regulatory issue that necessitates such an unorthodox (and in my view, clearly unlawful) approach to cost allocation. It is clear that Telstra's network will become progressively less used as customers migrate to the NBN. However, a better view is that

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<sup>9</sup> Whether or not the ACCC's proposed cost allocation method is an application of what the ACCC described as a "partial cost allocation" approach is not an important issue – I have not seen that term used outside of the current context. What is important is the substance and effects of the ACCC's proposed cost allocation method, which is the focus of this report.

<sup>10</sup> It is noted that the costs that are being disallowed are costs that the ACCC has decided are prudent and efficient (comprising the initial RAB and subsequently approved capital and operating expenditure).

Telstra's cost base is already low in anticipation of the declining demand (thus mitigating the potential for increasing unit costs as demand falls), in that:

- a. the initial RAB was set at a value that was only marginally above the ACCC's lower bound of depreciated historical (unindexed) costs, which is very low value compared to precedents from other sectors (where initial values are or close to replacement cost valuations are commonplace)
- b. forecasts of operating expenditure (which are approved explicitly by the ACCC) already reflect the opportunities for cost savings as network utilisation falls, and
- c. similarly, forecasts of capital expenditure (which are also approved explicitly by the ACCC) already reflect the opportunities for cost savings and indeed are declining at a rapid rate (particularly in relation to the customer access network assets, and
- d. the initial RAB and subsequent capital expenditure has been depreciated at a fast rate in comparison with other sectors and so is decreasing rapidly (this is not a criticism – I argued in a previous report that it is appropriate to accelerate depreciation so that fixed capital costs are spread more equitably over customers)

15. Lastly, while the ACCC asserts that what it wants is to protect customers from rising unit costs, the fact is that this outcome will already be achieved with a standard application of the building block approach. That is:

- a. If none of the “adjustments” discussed above are made, average prices in the 2015/16 to 2018/19 regulatory period would be only slightly higher in real terms (less than 1 percentage point) to 2014/15 prices
- b. If the individually redundant assets are removed from the RAB as disposals (but all other costs are recovered in full) then average prices in the 2015/16 to 2018/19 regulatory period will be approximately **0.8 per cent lower** in real terms than 2014/15 prices (indeed, prices will be **4.4 per cent lower** in real terms in the last year of the regulatory period), whereas
- c. If the ACCC's proposed adjustments are applied, then average prices in the 2015/16 to 2018/19 regulatory period will be approximately **15.0 per cent lower** in real terms than 2014/15 prices (indeed, prices will be **18.1 per cent lower** in real terms in the last year of the regulatory period).

16. Rather than protecting customers from rising unit costs as the ACCC assets, the further draft decision will result in substantial and (given the conclusions above) unjustified price reduction.

## 1.5 Structure of this report

17. The remainder of this report is as follows.

- a. Chapter 2 summarises in more detail the ACCC's decision and its reasoning, together with the advice that it received from Analysys Mason.

- b. Chapter 3 provides my assessment of the ACCC's further draft decision and the Analysys Mason advice. In this context, I address first the treatment of assets that will be progressively underutilised and then the assets that will become individually redundant given the greater materiality of the ACCC's decision in relation to be former (this is evident in the price impact figures set out in paragraph 14).
- c. Chapter 4 then contains the declaration required by the Federal Court's guidelines for expert witnesses.

## 2. Summary of the ACCC's further draft decision and Analysis Mason report

### 2.1 ACCC further draft decision

18. The ACCC has decided to separate its treatment of assets whose use is expected to be affected by the NBN into two classes, namely:
- a. Assets that will become individually redundant when customers migrate will be treated as a disposal, and removed from the regulatory asset base (RAB). The example of the local copper loop is provided as an example.
  - b. Where assets will continue to be used but will be used to a lesser extent as customers migrate to the NBN (“progressively under-utilised”),<sup>11</sup> then the ACCC will modify “the cost allocation factors to ensure that the increased unit costs associated with this under-utilisation will not be allocated to fixed line services”.<sup>12</sup>

19. The ACCC's reason for these adjustments is its view that:<sup>13</sup>

*The ACCC considers that remaining users of the fixed line network during the transition to the NBN should not bear costs they do not cause and which are associated with assets they will not use.*

20. The ACCC stated that treating assets in this way was consistent with the Fixed Principles.<sup>14</sup>
- a. In relation to the assets that will be individually redundant, the ACCC's further draft decision is that these can be treated as a disposal as that term is used in the Fixed Principles.<sup>15</sup> The ACCC refers to certain accounting standards in support of this view.
  - b. In relation to the assets that will be “progressively under-utilised”, the ACCC has said that the adjustment it proposes will be given effect as part of determining the “cost allocation factors”.<sup>16</sup> Its reason as to why this decision will meet the Fixed Principles is stated in less clear terms, and appears to be that:

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<sup>11</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.72.

<sup>12</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.73.

<sup>13</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.71.

<sup>14</sup> This is explained to be one of the topics dealt with in section 4.4.3 (ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.74). The Fixed Principles are set out in ACCC (2011), Final Access Determinations, June, clause 6.

<sup>15</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.74. The relevant Fixed Principle is ACCC (2011), Final Access Determinations, June, clause 6.7.

<sup>16</sup> The relevant Fixed Principle is ACCC (2011), Final Access Determinations, June, clause 6.14.



- i. Users of the fixed line network are not causing the excess capacity created by NBN migration, this excess capacity is caused by NBN migration
  - ii. Telstra had the opportunity to secure from NBN Co compensation to insulate it from any loss associated with the reduction in economies of scale, and
  - iii. The ACCC asserts that “the allocation of costs under its approach reflect the relative usage of Telstra’s fixed line network by various services that continue to use the network”,<sup>17</sup> although it is not explained how this conclusion follows from the preceding discussion.
21. The ACCC has stated that it has sought to remove the “incremental cost” associated with the overcapacity (which is one of the methods identified by Analysys Mason). In practice, however, the ACCC has adjusted the fully distributed cost allocation factors to be consistent with the unit costs of a hypothetical network (one where there was no NBN), which it described as follows:<sup>18</sup>
- *Step 1: Estimate unit costs for each asset class that would result if NBN-induced under-utilisation did not occur. These unit costs are estimated by replacing FLSM expenditure and demand inputs with ones that do not account for the impact of the NBN. For capital expenditure and demand, Telstra’s forecast model is used to determine pre-NBN forecasts. For operating expenditure, base year costs for each asset class are held constant in real terms over the regulatory period. In addition, adjustments are made to cost allocations to remove NBN-related adjustments.*
  - *Step 2: Calculate the proportionate difference between unit costs calculated by the FLSM (using draft decision inputs and unadjusted cost allocation factors) and the unit costs estimated under Step 1. The difference represents the per asset class cost of NBN-induced excess capacity as a proportion of total unit costs.*
  - *Step 3: Scale down allocation factors for each asset class by the proportionate cost of excess capacity calculated under Step 2. That is, multiply allocation factors by 1 minus the proportionate difference in unit costs arising from NBN-induced excess capacity.*

## 2.2 Analysys Mason advice

22. The advice to the ACCC from Analysys Mason recommended to the ACCC that assets be separated into those that can be made individually redundant (referred to as “scalable”) from the remainder (“non-scalable”), and that the former only be considered as disposals. This view (which the ACCC accepted) was a change to the Draft Decision, where assets with unused capacity were also deemed to be disposals.

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<sup>17</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.76.

<sup>18</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.73-74.

23. In forming its views, Analysys Mason set out a list of what it considered to be appropriate principles for guiding decisions about the allocation of costs, which included cost causation, distribution of the benefits and cost minimisation.<sup>19</sup>
24. In relation to the non-scalable assets, Analysys Mason appeared to assume – albeit without providing reasons – that the cost allocation step first required an assessment of whether there is “overcapacity” or a loss of economies of scale,<sup>20</sup> and specific consideration given to how this portion of the cost should be allocated.<sup>21</sup> It posited two options for how this share of the cost should be allocated, which are:
- a. to allocate this across the users of the “used” capacity, which is says should be done if the overcapacity cannot be allocated to a particular party or group, or
  - b. to allocate this cost to “Telstra corporate” given that Telstra (as a corporate entity) “retains the right to use the overcapacity”,<sup>22</sup> and because this would avoid allocating a loss of economies of scale to fixed-line service subscribers.<sup>23</sup>
25. In relation to this last matter, Analysys Mason acknowledge that “[t]he use of a BBM model and fully allocated CAF means that all required revenues calculated for the BBM should be recovered”,<sup>24</sup> and notes that for this to be satisfied a finding is required that the compensation paid to Telstra under the Definitive Agreements achieves this purpose.<sup>25</sup>
26. In terms of the method for deriving the “overcapacity”, Analysys Mason defines two methods, one of which is described as an “average costing” approach and the second an “incremental costing” approach.<sup>26</sup> The objective of the latter is stated as to remove from the RAB (through the cost allocation approach) just the portion of costs associated with the assets associated with the unused capacity.
27. Lastly, Analysys Mason also opines that the ACCC is not bound to apply a fully-allocated cost framework, and would be free instead to set prices on the hypothetical assumption that there is no NBN, that is, assuming (again hypothetically) that Telstra continues to serve the full fixed line services market. This would result in

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<sup>19</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, pp.6-9.

<sup>20</sup> I note that the ACCC and its advisor refer to “diseconomies of scale” in their respective reports. However, this is an incorrect description of the issue. Instead, the proper description of the issue is a loss of economies of scale. As such, I have applied this correct terminology in place of the language of the ACCC and its advisor in this report.

<sup>21</sup> This is implicit in principle 2a of Figure 2.2 (Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, p.11).

<sup>22</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, p.16.

<sup>23</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, p.16.

<sup>24</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, p.16.

<sup>25</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, pp.16-17.

<sup>26</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, p.17.

prices that would permit full recovery of the benchmark revenue requirement in an ex-NBN world, which it attests is “the scenario for which the BBM and fixed principles were developed for”.<sup>27</sup>

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<sup>27</sup> Analysys Mason (2015), Assessment and verification of inputs into Telstra’s cost allocation framework, June, pp.17-18.

### **3. Analysis**

#### **3.1 Assets that will be “progressively underutilised”**

##### **3.1.1 Proposed cost allocation is not consistent with the Fixed Principles**

28. The ACCC’s new proposed cost allocation method is, in effect, a reversion by the ACCC to the “partial cost allocation” approach that I commented upon extensively in my first report,<sup>28</sup> notwithstanding the ACCC’s subsequent position that it intends to implement a fully distributed cost method.
29. I base this conclusion on the fact that the ACCC proposes to commence with cost allocation factors that are based upon an orthodox fully distributed cost allocation method, but then adjust those factors down. This is the result of Step 3 in the ACCC’s method that was quoted in paragraph 21 above. The downward adjustment is done to implement the ACCC’s view that:
- a. the unit cost of a hypothetical network (one without the NBN) would be lower than the actual network (the latter being based upon actual costs and demand), and that
  - b. access charges should be limited to the unit costs that would be observed in this hypothetical network (rather than in the actual network).
30. Accordingly, my key complaints about the “partial cost allocation” approach apply equally to the cost allocation method the ACCC has said it now intends to apply, namely that such an adjustment (and with an outcome whereby prices are set, in effect, based on hypothetical costs and demand rather than actual costs and demand):
- a. is simply not done when applying the building block approach (with the use of the building block approach being mandated by the Fixed Principles)
  - b. generates outcomes that are inconsistent with the implicit objective of the building block approach, and
  - c. is inconsistent with the specific requirements of the Fixed Principles in relation to cost allocation factors and demand forecasts. I elaborate upon these matters below.

##### ***Inconsistent with the application of the building block approach***

31. The outcome of the cost allocation factors that the ACCC proposes to apply is that a material share of the revenue requirement will not be allocated to a service or a user for which there is a corresponding revenue stream being generated. Rather, a share of the revenue requirement will simply be unrecoverable.

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<sup>28</sup> Incenta Economic Consulting (2015), Cost allocation for fixed line services, October.

32. As I concluded in my first report,<sup>29</sup> a cost allocation method that generates such an outcome is not consistent with the application of the building block approach to setting prices because it does not bring with it a prospect that costs prudently and efficiently incurred will be recoverable.<sup>30</sup> Accordingly, as the Fixed Principles require the application of the building block approach, the ACCC's proposed cost allocation method does not meet the Fixed Principles.

***Inconsistent with the Fixed Principles requirements for cost allocation***

33. The ACCC's proposed cost allocation method also does not comply with the direct requirements in relation to cost allocation in the Fixed Principles. The specific requirements of the Fixed Principles in relation to cost allocation are as follows:

*6.14 Cost allocation factors*

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

*(b) Direct costs should be attributed to the service to which they relate.*

*The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.*

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

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

34. The allocation of costs that the ACCC now proposes, and the reasoning of Analysys Mason in relation to its second option, are plainly inconsistent with this principle.
35. Both the ACCC and Analysys Mason reason that there is “overcapacity” in parts of the fixed line network and then ask who is the cause of this “overcapacity” or who will benefit from the “overcapacity”. An estimate of the cost associated with the deemed “overcapacity” is then allocated to the party that is deemed to be responsible for, or benefitting from, the overcapacity, which is reasoned to be “Telstra corporate”.
36. However, the process that is adopted by both the ACCC and Analysys Mason is not the process that is envisaged by the Fixed Principles. As noted above, the Fixed Principles require costs to be allocated according to:
- a. The relative usage of the network, and
  - b. According to causal relationships between supplying services and incurring costs.
37. It is a nonsense to say that customer migration to the NBN is either contributing to additional usage of the fixed line assets or is causing fixed line costs. Customer migration

<sup>29</sup> Incenta Economic Consulting (2015), Cost allocation for fixed line services, October.

<sup>30</sup> It is noted that the costs that are being disallowed are costs that the ACCC has decided are prudent and efficient (comprising the initial RAB and subsequently approved capital and operating expenditure).

to the NBN is doing the exact opposite – it is creating non-use of the assets, and as a consequence it is causing a reduction in costs (forward-looking costs that is).

38. It is noted that Analysys Mason attempts to justify the allocation of costs to “Telstra corporate” in a manner that is more consistent with the Fixed Principles on the basis that it is Telstra who retains the option to utilise this overcapacity in the future. However, providing an allocation on this basis is jumping the gun. If Telstra is able to use some of the “over capacity” in the future then an allocation will then be authorised by the Fixed Principles (as this use will then be part of the “relative usage”, and at which time it will be reasonable to infer that an additional revenue stream is being earned). Prior to this point, however, the “over capacity” is not being used cannot be allocated to Telstra Corporate in accordance with the Fixed Principles.
39. In a similar vein, both the ACCC and Analysys Mason refer to the objective as being one of deciding how to allocate a loss of economies of scale or “unit costs”. However, this expression is itself economically meaningless and serves to highlight the imprecision and confusion of the ACCC and Analysys Mason on this matter. To be clear, *costs* can be allocated and *demand* can be forecast, and the outcome of these steps is an implied unit cost (and, if unit cost is higher than previously as a consequence of a fall in demand, then a diseconomy of scale can be said to have arisen).

***Inconsistent with the Fixed Principles requirements for demand forecasts***

40. Clause 6.11 of the Fixed Principles mandates the use of demand forecasts when setting regulated prices that reflect the best forecast of the sales of the fixed line services over the regulatory period ahead. That is, under an application of the building block approach as required by the Fixed Principles, the process for deriving access charges is simply to:
  - a. First derive annual revenue requirements that match the cost of service over the period (in turn reflecting forecasts of prudent and efficient expenditure), and
  - b. Secondly, dividing the annual revenue requirements by forecasts of actual demand to derive the access prices (this second step may be slightly more complex if a smooth price path is determined, but this does not affect the conclusions below).
41. The outcome of these steps is that there will be a one-for-one relationship between service prices that are derived and the forecasts of actual demand.
42. However, the outcome of the adjustments that the ACCC proposes to apply in the cost allocation step is that there will be little or no relationship between the access prices and the forecasts of actual demand. Rather, the effect of the ACCC’s adjustments to the cost allocation factors is that the access prices will be calibrated to the ACCC’s estimate of the unit costs of a network in a hypothetical world (i.e., one where there is no NBN). This outcome is quite clear from how the ACCC has described the derivation and application of its adjustment factors (as quoted in paragraph 21 above). The forecast of demand that drives the estimate of the hypothetical unit cost – and thereby the access prices – is the forecast of demand in the hypothetical (no-NBN) world.

43. Accordingly, the regulated prices the ACCC proposes to set cannot be said to have been set on the basis of the forecast of (actual) sales over the forthcoming regulatory control period. Instead, the method will result in the access prices being driven by the forecast of a demand in hypothetical world. Thus it is clear that the Fixed Principle in relation to demand forecasts has not been met.

### **3.1.2 ACCC decision and Analysys Mason advice misinterprets the purpose of the compensation under the Definitive Agreements**

44. As noted in my previous report, the nature or purpose of the compensation under the Definitive Agreements is of no relevance – the Fixed Principles simply do not authorise the adjustments that the ACCC proposes.
45. Nevertheless, I note that Analysys Mason acknowledges that in order for the allocation of the “overcapacity” to “Telstra corporate” to be consistent with the objective of the building block approach that a positive finding is required that Telstra will be compensated for this loss through the payments that are received under the Definitive Agreements.
46. On this point, as I concluded in my previous report, the evidence that I have seen makes it clear that the compensation in the Definitive Agreements was not for this purpose. Instead, from the evidence presented to me I could conclude that the payments between NBN Co and Telstra were for infrastructure access payments for the use of certain assets, infrastructure ownership payments for asset transfers, and disconnection payments which provide partial compensation for the loss of an ongoing business after the roll-out of the NBN.<sup>31</sup>
47. The ACCC commented that it did not consider the actual purpose of the compensation in the Definitive Agreements to be relevant, rather all that was required was that Telstra had the opportunity to seek compensation for the potential loss that it would suffer, which the ACCC considered to be the case.<sup>32</sup>
48. I disagree with the ACCC’s view that it is reasonable to expect that Telstra would have – and indeed, could have – sought compensation in expectation that the ACCC would seek to make Telstra absorb the consequences of the loss of economies of scale as it now proposes. The reason for this is because – as I discussed more fully in my previous report – what the ACCC currently proposes is plainly inconsistent with the Fixed Principles.<sup>33</sup> Rather, the Fixed Principles are very clear that the ACCC is to apply a conventional building block approach when calculating fixed line service prices, and as part of which to apply a conventional allocation of costs (and one that is based upon “relative usage”).

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<sup>31</sup> Incenta Economic Consulting, ‘Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services – Report for Gilbert + Tobin’, April 2015, pp. 23-24.

<sup>32</sup> ACCC (2015), Public inquiry into final access determinations for fixed line services – primary price terms: Further draft decision – outstanding issues, June, p.

<sup>33</sup> Incenta Economic Consulting, ‘Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services – Report for Gilbert + Tobin’, April 2015, pp. 24-25.

There would therefore have simply been no reason to expect there would be any reason to seek the compensation the ACCC now posits.

### **3.1.3 The adjustment the ACCC proposes is inconsistent with the LTIE and unreasonable**

49. The approach taken by the ACCC and Analysys Mason to cost allocation is inconsistent with the objects clause of Part XIC of the *Competition and Consumer Act 2010 (Cth)*. This is because it does not encourage economically efficient investment. The Act requires also that in determining the extent to which economically efficient investment is achieved that regard be given to the legitimate commercial interests of the supplier, namely Telstra. It is clear also that Telstra's legitimate commercial interests are not supported by the ACCC's cost allocation approach. This is because the approach of the ACCC and its advisors ensures that Telstra cannot expect to earn at a normal return on investment but it can instead expect to make a loss. Consequently, it will not be motivated to undertake necessary economically efficient investment, which is an outcome that is inconsistent with the LTIE.
50. Telstra has a substantial and real ongoing investment requirement in order to provide a continuity of service for fixed line services provided over the copper network in the period prior to the full transition to the NBN. The proposed approach by the ACCC will have a real and detrimental impact on the expectations for cost recovery and so the incentives for future economically efficient investment to proceed. Notably, I am advised that approximately that more than 70 per cent of the revenue requirement that the ACCC's method will yield unrecoverable relates to capital expenditure that has or will be undertaken since the initial RAB was set (i.e., from 2009/10 onwards) or operating expenditure, with operating expenditure alone accounting for over one third of the disallowance.<sup>34</sup> Given this includes forecast amounts that have been approved by the ACCC, the prudence of this expenditure is not in question.
51. The ACCC itself has acknowledged in its Draft Decision the need for new investment on the fixed line network and so the preservation of incentives for this investment to proceed. Specifically, in the case of data equipment, the ACCC justified its previous view not to write down the value of data equipment on the basis that growth in SIO traffic necessitated the preservation of incentives for ongoing investment.<sup>35</sup> The ACCC's revised approach, however, now removes incentives for such investment to take place. Given the absence of any explanation of how the proposed approach maintains an investment incentive, I must conclude that this objective has been abandoned in favour of achieving a certain price outcome. Given the detrimental impact this outcome has on the encouragement of economically efficient investment and Telstra's legitimate business interests, it is clearly an outcome that is inconsistent with the LTIE.

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<sup>34</sup> This information has been given to me by Telstra, the derivation of which I understand will be addressed in its submission to the ACCC.

<sup>35</sup> ACCC, Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, pp. 139-140.



### 3.1.4 The pricing issue the ACCC is seeking to address does not exist

52. The ACCC has stated in several places that it has an objective to achieve a certain price outcome, namely to prevent an increase in unit costs flowing from the migration of customers to the NBN. However, it has not been specific about the precise magnitude of this effect and therefore the extent of the perceived problem. One reason for the silence from the ACCC on this matter may be due the absence of an actual problem.
53. The most material of the adjustments the ACCC proposes is in relation to non-scalable assets. I have calculated if the non-scalable assets were to remain fully recoverable then the average price over the 2015/16 to 2018/19 regulatory period would **decline in real terms by 0.8 per cent** compared to 2014/15 prices (and be **4.4 per cent lower** in real terms in the last year of the regulatory period).<sup>36</sup> In addition, even with the scalable assets (i.e., those discussed in section 3.2 of this report) retained in the RAB and so fully recoverable, the average price in the 2015/16 to 2018/19 regulatory period would be only marginally higher (less than one percentage point) in real terms than the 2014/15 prices.<sup>37</sup> In contrast, average prices in real terms under the ACCC further draft decision would be **15.0 per cent lower** than 2014/15 prices, and finish at **18.1 per cent lower** in real terms by 2018/19.
54. I am not surprised that the decline in utilisation is not translating into a corresponding increase in prices – my reasons for this are set out in section 3.1.5. However, I observe that with real average prices in decline or, at worst, largely constant, in the absence of the ACCC’s proposed adjustment, it is not clear exactly what problem the ACCC is seeking to resolve.

### 3.1.5 The ACCC has not removed just the incremental cost associated with “overcapacity” (but has disallowed much more)

55. The ACCC has stated that it has applied what Analysys Mason describes as its “incremental costing” approach for identifying the cost associated with the “overcapacity”.<sup>38</sup> While it is my clear view that no adjustment can, or should, be made with respect to “overcapacity”, it is also clear that the ACCC has not applied the approach described by its advisor. Instead it has applied an adjustment that would be

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<sup>36</sup> I have calculated these real price changes from the ACCC’s spreadsheet model, which Telstra provided to me. I found that if the ACCC’s adjustment to the cost allocation factors was switched off, then the one-off price reduction of 9.6 per cent became instead a one-off price increase of 5.5 per cent. I calculated the implied real annual prices and price changes using the forecast of inflation that was contained in the model (which was 2.5 per cent).

<sup>37</sup> This figure is based upon advice to me from Telstra that the effect of adding back the “disposed” assets after already turning off the adjustment to the cost allocation factors is to raise the one-off price change by approximately 1.5 percentage points (i.e., from 5.5 per cent to 7.0 per cent).

<sup>38</sup> If an adjustment were to be made – which, for all of the reasons given above and below I consider is neither authorised nor justified – then the “incremental costing” approach would be preferred because this attempts to put customers in the same position as if the unused capacity did not exist. The average costing approach, in contrast, would bestow a positive benefit on current customers as a consequence of there being unused capacity (this is because current customers would get the benefit of scale economies that just are not achievable with the level of current demand).

expected to materially overstate the “incremental cost” associated with the “overcapacity”.

56. In order to derive the *incremental cost* associated with any “overcapacity”, an assessment is required of the extent by which the cost base is higher as a result of the additional capacity. To the extent that fixed costs account for a large share of costs, and noting that (prudent and efficient) operating expenditure will inherently adjust to the actual level of use, then economic principles suggests that the cost associated with there being additional capacity may be very small.<sup>39</sup>
57. The adjustment the ACCC has done is quite different. In effect, the ACCC has merely pro-rated down the revenue requirement (when deriving prices) in proportion to the deemed reduction in usage attributable to migration to the NBN. The presence of fixed costs in the cost structure of the fixed line services means that the ACCC’s adjustment would be expected to substantially overstate the incremental cost associated with the additional capacity. The outcome of this is that the current customers would receive a positive benefit as a consequence of there being unused capacity – rather than merely being insulated from the consequences of the additional capacity – because they will get the benefit of scale economies that just are not achievable with the level of current demand.
58. My view is that a more reasonable assumption is that the revenue requirement for the 2014/15 to 2019/20 regulatory period already reflects a situation whereby current customers are not (and will not) pay more on account of there being additional network capacity. My reasoning in this regard is as follows.
  - a. First, Telstra’s forecast of operating expenditure has already been reduced to account for the costs that can be avoided as a consequence of the migration of customers to the NBN. Given that the operating expenditure has already been reduced to reflect forecast demand (after customer migration), no operating expenditure can be deemed to be caused by the presence of unused capacity.
  - b. Secondly, in relation to capital costs, whether the cost base is higher today (and in the future) as a consequence of the overcapacity depends crucially on how the initial RAB for the fixed line network was determined, and the manner in which that cost (and subsequent capital expenditure) has been recovered over the intervening period. In this regard, I observe that:
    - i. The initial RAB was set at a value that was only marginally above the ACCC’s lower bound of depreciated historical (unindexed) costs and so at a level that was materially lower than the level that would have been consistent with the precedent established in other regulated industries for assets that are expected to have substantial remaining lives (i.e. at or very close to a current replacement cost valuation). It is difficult to imagine that this decision was not influenced by the expectation of customer migration to the NBN.

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<sup>39</sup> As I note below, the additional cost that exists today as a result of there being unused capacity also depends on how costs have been recovered in the past.

- ii. The forecast of capital expenditure, which is approved by the ACCC, is forecast to fall significantly compared to historical levels. While a certain level of capital investment is still required in order to maintain continuity of supply (particularly in relation to core assets), the level of overall capital expenditure is forecast to fall materially, with a substantial reduction in capital expenditure to be undertaken in relation to customer access network assets.
- iii. The rate of depreciation that is used for fixed line services pricing is fast in comparison to other regulated sectors. This is because, even putting aside the question of remaining lives, the use of historical cost depreciation for telecommunications, rather than a current cost method (whereby the RAB is escalated for CPI) generates a much faster decline in the RAB. This statement is not intended to be a criticism – as I argued in my previous report, the correct response to an expected decline in usage is to accelerate depreciation so that more of the fixed capital cost is recovered when usage is higher (and so remove the potential for prices to increase).

59. Indeed, I note that my proposition that it is reasonable to assume that the cost associated with the overcapacity has already been removed from the cost base merely requires the assumption that the ACCC's previous decisions have been correct.

### **3.1.6 The Fixed Principles do not authorise a hypothetical ex-NBN price**

60. As I have explained in previous reports, the Fixed Principles require a standard building block calculation to be applied. In particular I note that the Fixed Principles require:
- a. The use of the initially determined RAB, which is to be carried forward according to the prescribed formula
  - b. Operating expenditure is to reflect forecasts of prudent and efficient actual expenditure
  - c. Capital expenditure also to reflect forecasts of prudent and efficient actual expenditure requirements
  - d. A method of cost allocation that is consistent with providing a reasonable opportunity for prudent and efficient costs to be recovered, and one that is centred squarely on relative use and/or cost causation, and
  - e. The demand forecasts to reflect forecasts of actual demand, using an appropriate methodology, applying reasonable assumptions, and utilising the best available information.
61. Given these specific requirements of the Fixed Principles, the hypothetical ex-NBN price that Analysys Mason says the ACCC would be permitted to do cannot be done.
62. Analysys Mason is also asserting – and asserting incorrectly – that the Fixed Principles were developed on the assumption of there not being an NBN. This is incorrect. The NBN was already a commitment of the Commonwealth Government at the time the

Fixed Principles were written and, as I noted in an earlier report, the Fixed Principles were drafted at the same time as the negotiation of the Definitive Agreements (such that each was able to take account of the other).<sup>40</sup>

## 3.2 Assets that will be individually redundant

### 3.2.1 Redundant assets are not disposals within the Fixed Principles

63. The ACCC has maintained its view that individually redundant assets fall within the definition of a “disposal” as that term is used in the Fixed Principles. The ACCC’s argument is that an asset that is no longer useful falls within the ambit of a disposal. In contrast, in my previous report, I argued that the definition that is most consistent with the application of the building block approach is that there had been a “transaction” in relation to asset. I said this because a transaction would be required for it to be reasonable to make an inference that an alternative source of cost recovery for the asset was created (so that the objective inherent in the building block approach was achieved).<sup>41</sup>
64. I maintain that my previous view on the appropriate definition of disposals (within the context of applying the building block approach) is correct. I also note that the idea that the unrecovered cost associated with unused assets could nonetheless be recovered under the building block approach is consistent with an orthodox application of the building block approach. This issue – and a reference to a recent decision of the ACCC’s sister organisation, the Australian Energy Regulator (AER) – is addressed in the next section.
65. I observe, however, that the ACCC has relied upon the accounting standard relevant to property plant and equipment (AASB 116) to support its view that an individually redundant asset necessarily is also a disposal. I acknowledge that financial accounting principles are a matter that is beyond my area of direct expertise; however, a simple reading of AASB 116 suggests to me that my definition of a disposal is more consistent with how the term disposal is used in that standard.
66. In particular, Clause 67 of accounting standard AASB 116 defines when an asset is derecognised, and is framed as follows:
- The carrying amount of an item of property, plant and equipment shall be derecognised:*
- (a) on disposal; or*
- (b) when no future economic benefits are expected from its use or disposal.*
67. The plain implication of this clause is that something can generate no future economic benefit (and therefore be required to be derecognised) and yet not be a disposal. In

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<sup>40</sup> Incenta Economic Consulting, ‘Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services – Report for Gilbert + Tobin’, April 2015, p. 25.

<sup>41</sup> Incenta Economic Consulting, ‘Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services – Report for Gilbert + Tobin’, April 2015, p. 7.

addition, clause 69 of the standard proceeds to describe the manner in which a disposal can occur, and is as follows:

*The disposal of an item of property, plant and equipment may occur in a variety of ways (e.g. by sale, by entering into a finance lease or by donation). In determining the date of disposal of an item, an entity applies the criteria in AASB 118 for recognising revenue from the sale of goods. AASB 117 applies to disposal by a sale and leaseback.*

68. This clause is also consistent with my definition that there needs to be some form of transaction in relation to the asset in order for a disposal to exist. Relevantly, this clause does not say that a disposal will be deemed whenever an asset is no longer useful as the ACCC asserts.

### **3.2.2 Recovering the cost of unused assets is orthodox under the building block approach**

69. As stated noted above, where assets are no longer used, the orthodox approach under the building block approach is that the costs are nonetheless still recovered.<sup>42</sup> A recent and relevant example of this was the approach to electricity assets destroyed by cyclone in Queensland. In this case, even though the assets were clearly no longer in service the AER sought to ensure cost recovery was maintained. In doing so, it noted that their value could simply be retained in the RAB or accelerated depreciation could be applied, with each option being NPV neutral. The AER explained its position more fully in its Draft Decision, stating:<sup>43</sup>

*The AER notes that both approaches to dealing with the destroyed assets (that is, leaving the assets in the RAB or using accelerated depreciation) will yield the same NPV outcome over the life of the assets (that is, either approach would be consistent with clause 6.5.5(b)(2) of the NER). However, the timing of the cash flows is different under each approach. If the assets are left in the RAB, Ergon Energy will recover the value of these assets over the remaining lives of the assets. Under the accelerated depreciate proposal, the value of the assets would be returned more quickly. Ergon Energy proposed a single revenue adjustment in the first year of the next regulatory control period equal to the remaining value of these destroy assets as at 1 July 2010.*

*The AER considers that, since the destroyed assets are no longer providing a service, it is consistent with clause 6.5.5 (b)(1) of the NER to allow these assets to be depreciated more quickly. The AER accepts Ergon Energy's proposal that the remaining value be returned in full in the first year of the next regulatory control period. The remaining value of these assets, however, should be adjusted to \$10 million as at 1 July 2010, to correct for the error noted above.*

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<sup>42</sup> The objective is normally to recover costs over the period that an asset is useful. Thus, for there to be unrecovered costs, there either needs to have been some defect in the regulatory regime (namely, the rate of depreciation being too slow) or something unexpected to have occurred. The latter is the cause of the unrecovered cost in the example provided here.

<sup>43</sup> AER, 'Draft decision Queensland Draft distribution determination 2010–11 to 2014–15 25', November 2009, p.226.

70. I note that in the exceptional case where the asset is removed from the RAB this also is not referred to as a disposal but instead is referred to as the assets being made *redundant* or *stranded*. In the case where I am aware of this being permitted (the rules for regulating gas networks) it is a power that can only be applied following the specific inclusion of such a mechanism in advance, and is exercised under clear safeguards, including the requirement for the associated risk to be compensated.<sup>44</sup>
71. As indicated in my previous report, assets that have been transferred to NBN Co for a fee are clearly disposals. In this case there is a basis for a reasonable belief that Telstra would have recovered the remaining regulatory cost from NBN Co. Similar to the case of the Queensland electricity assets identified above, the same is not true, however, for assets that are simply no longer used. As indicated previously, the evidence presented to me suggests there is no reason to believe Telstra would have been compensated for assets that are made individually redundant as a consequence of the decline in demand caused by the NBN. In this case in order for the objectives of the building block approach to be maintained it is necessary for an expectation for full cost recovery to be maintained.

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<sup>44</sup> Section 85 of the National Gas Rules.

#### **4. Declaration**

72. I have has made all of the inquiries that I believe to be desirable and appropriate in the preparation of this report and no matters of significance that I regard as relevant have, to my knowledge, been withheld.



Jeffrey John Balchin  
17 July 2015

**A. Guidelines for Expert Witnesses in Proceedings in the  
Federal Court of Australia**



**FEDERAL COURT OF AUSTRALIA**  
***Practice Note CM 7***  
**EXPERT WITNESSES IN PROCEEDINGS IN THE**  
**FEDERAL COURT OF AUSTRALIA**

*Practice Note CM 7 issued on 1 August 2011 is revoked with effect from midnight on 3 June 2013 and the following Practice Note is substituted.*

**Commencement**

1. This Practice Note commences on 4 June 2013.

**Introduction**

2. Rule 23.12 of the Federal Court Rules 2011 requires a party to give a copy of the following guidelines to any witness they propose to retain for the purpose of preparing a report or giving evidence in a proceeding as to an opinion held by the witness that is wholly or substantially based on the specialised knowledge of the witness (see **Part 3.3 - Opinion** of the *Evidence Act 1995* (Cth)).
3. The guidelines are not intended to address all aspects of an expert witness's duties, but are intended to facilitate the admission of opinion evidence<sup>1</sup>, and to assist experts to understand in general terms what the Court expects of them. Additionally, it is hoped that the guidelines will assist individual expert witnesses to avoid the criticism that is sometimes made (whether rightly or wrongly) that expert witnesses lack objectivity, or have coloured their evidence in favour of the party calling them.

**Guidelines**

**1. General Duty to the Court<sup>2</sup>**

- 1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.
- 1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential.
- 1.3 An expert witness's paramount duty is to the Court and not to the person retaining the expert.

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<sup>1</sup> As to the distinction between expert opinion evidence and expert assistance see *Evans Deakin Pty Ltd v Sebel Furniture Ltd* [2003] FCA 171 per Allsop J at [676].

<sup>2</sup>The "*Ikarian Reefer*" (1993) 20 FSR 563 at 565-566.

## 2. The Form of the Expert's Report<sup>3</sup>

- 2.1 An expert's written report must comply with Rule 23.13 and therefore must
- (a) be signed by the expert who prepared the report; and
  - (b) contain an acknowledgement at the beginning of the report that the expert has read, understood and complied with the Practice Note; and
  - (c) contain particulars of the training, study or experience by which the expert has acquired specialised knowledge; and
  - (d) identify the questions that the expert was asked to address; and
  - (e) set out separately each of the factual findings or assumptions on which the expert's opinion is based; and
  - (f) set out separately from the factual findings or assumptions each of the expert's opinions; and
  - (g) set out the reasons for each of the expert's opinions; and
  - (ga) contain an acknowledgment that the expert's opinions are based wholly or substantially on the specialised knowledge mentioned in paragraph (c) above<sup>4</sup>; and
  - (h) comply with the Practice Note.
- 2.2 At the end of the report the expert should declare that "[the expert] has *made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert's] knowledge, been withheld from the Court.*"
- 2.3 There should be included in or attached to the report the documents and other materials that the expert has been instructed to consider.
- 2.4 If, after exchange of reports or at any other stage, an expert witness changes the expert's opinion, having read another expert's report or for any other reason, the change should be communicated as soon as practicable (through the party's lawyers) to each party to whom the expert witness's report has been provided and, when appropriate, to the Court<sup>5</sup>.
- 2.5 If an expert's opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report.
- 2.6 The expert should make it clear if a particular question or issue falls outside the relevant field of expertise.
- 2.7 Where an expert's report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports<sup>6</sup>.

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<sup>3</sup> Rule 23.13.

<sup>4</sup> See also *Dasreef Pty Limited v Nawaf Hawchar* [2011] HCA 21.

<sup>5</sup> The "*Ikarian Reefer*" [1993] 20 FSR 563 at 565

<sup>6</sup> The "*Ikarian Reefer*" [1993] 20 FSR 563 at 565-566. See also Ormrod "*Scientific Evidence in Court*" [1968] Crim LR 240

**3. Experts' Conference**

- 3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

J L B ALLSOP

Chief Justice

4 June 2013