IT'S HOW WE CONNECT

TELSTRA CORPORATION LIMITED

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

Response to ACCC further draft decision

17 July 2015

Public version

Table of Contents

Executive Summary..3

1. NBN impacts and loss of economies of scale..6

2. Other issues raised in the Further Draft Decision..34

Attachment 1: NBN timeline..35

Attachment 2: The counterfactual..55

Attachment 3: Response to ACCC queries re expenditure forecasts..62

Attachment 4: Expert report of Jeff Balchin..71

Attachment 5: Expert report of Keith Lockey..72

Attachment 6: Statement of [redacted]

Attachment 7: Statement of [redacted]

Executive Summary

Telstra welcomes the opportunity to respond to the Australian Competition and Consumer Commission's (**ACCC**) Further Draft Decision on primary price terms for the Final Access Determinations (**FADs**) for the declared fixed line services.[1]

The Further Draft Decision represents a key milestone in the ongoing inquiry into the FADs. Following the provision of further information by Telstra and extensive review by the ACCC and its consultants, the ACCC has largely accepted as reasonable and prudent Telstra's forecast operating and capital expenditure for the period to FY2019. Further, the ACCC has also accepted (with some minor modifications) the detailed cost allocation framework put forward by Telstra.

The ACCC has also accepted in principle the need to adopt a fully allocated cost approach for the purpose of applying the Fixed Principles to determine prices.

Reaching a general agreement on the costs of supporting the fixed line network and supplying the fixed line services, and how those costs relate to different network users, is a key step in implementing the building block pricing framework established by the ACCC in 2011.

The ACCC adopted and industry supported a building block model to overcome uncertainty and unpredictability which resulted from the periodic 'optimisation' of the asset base as part of each price review under the previous TSLRIC+ pricing approach. To this end, the ACCC committed to implementing the building block model consistently over time through the introduction of Fixed Principles. The primary benefit of adopting and 'locking in' a building block model was that it moved fixed services pricing away from being based on hypothetical costs, and ensured prices would be determined based on actual historic costs (together with any prudent forecasts costs) and the best currently available view of forecast demand over the next regulatory period.

Telstra is pleased that following the provision of further detailed material on its cost forecasts, the ACCC has largely accepted Telstra's revised cost forecasts and has acknowledged that the per unit cost of supplying the fixed line services will increase – in nominal terms – over the period to FY2019. Although there are certain issues that remain unresolved within the Further Draft Decision, this version of the ACCC's model shows that a once-off, nominal price increase of 5.5% is required in order for Telstra to have an opportunity to recover the relevant costs of supplying the fixed line services. Accounting for inflation, a once of increase of 5.5% is equivalent to a <u>reduction</u> in prices in real terms of 4% by FY2019.

The ACCC has, however, made a further draft decision that the prices for fixed line services should not increase consistent with the increase in unit costs. Instead, contrary to the ACCC's Fixed Principles, its building block model and its review of Telstra's unit costs, the ACCC states in the Further Draft Decision that "costs associated with NBN-induced loss of scale economies should not be reflected in regulated revenues."[2] On this basis, the ACCC proposes a new allocation adjustment and a disposal adjustment that reduce regulated prices to remove the effect of "loss of economies of scale" arising from the migration of end users off the legacy copper network and onto the NBN.

The allocation adjustment involves scaling down Telstra's 'real-world' unit costs so that they reflect a view of unit costs in a hypothetical world in which NBN does not exist at all (and demand is consequently higher, but total costs remain relatively flat). The allocation adjustment alone leads to a proposed reduction in current prices of -9.6%, which is equivalent to a 15 percentage point reduction in prices from the 5.5% nominal increase that would occur if prices increased in line with the 'real-world' unit cost. Taking into account inflation, the ACCC's proposed adjustment results in a drop in prices of more than 18% by FY2019.

[1] Unconditioned Local Loop Service (**ULLS**); Line Sharing Service (**LSS**); Wholesale Line Rental (**WLR**); Local Carriage Service (**LCS**); Fixed Originating and Terminating Access (**FOAS and FTAS**); and Wholesale ADLS (**WDSL**).

[2] Further Draft Decision, p 11.

The allocation adjustment acts only to limit Telstra's ability to recover its legitimate costs, and so should be removed.

The disposal adjustment involves removing assets from the regulatory asset base (**RAB**), for example PSTN switching equipment, that are considered to be less utilised as NBN migration progresses but are not transferred to NBN. Those assets should not be disposed of and should be depreciated in accordance with standard economic and accounting practices. For the avoidance of doubt, Telstra agrees that the ACCC rightfully disposes of assets used for the provision of FTTN that Telstra has agreed to transfer to NBN, for example copper cable.

It is incorrect for the ACCC to seek to support these adjustments on the basis that "costs associated with NBN-induced loss of scale economies should not be reflected in regulated revenues".[3] The costs that the ACCC is removing through the adjustments are not related to the NBN, to the migration of services to the NBN or to the provision of NBN services. Rather, the costs that the ACCC is denying Telstra the opportunity to recover are costs faced by Telstra in supporting the fixed line network and supplying the fixed line services.

The combined impact of the allocation and disposal adjustments is a removal of [redacted] in revenue allowed to be recovered from the declared fixed-line services over the period FY2016-19. Of this, the allocation adjustment accounts for [redacted] and a further [redacted] is caused by the disposal adjustment.[4] More than 70% of the impact from the allocation adjustment is due to the removal of operating expenditure and capital costs (return on capital and depreciation) related to capital deployed from 2009/10 onwards (i.e. after the establishment of the initial RAB in July 2011), with more than a third due solely to disallowance of operating expenditure.

For the following reasons, there is no reasonable justification for either the allocation adjustment or the disposal adjustment:

- The ACCC's reasoning is based on a principle that a potential increase in "unit costs" in the future, resulting from the Government's NBN policy, is a form of "cost" that can be separately calculated and then allocated. This is not the case. First, far from NBN *increasing* costs - Telstra's costs are *falling* over the period (and Telstra's costs have been lower over the last five years as a result of the rollout of the NBN). "Unit costs" are not a different type of cost that can be separately measured and allocated – they are simply a way of expressing how total costs are shared per user, given total forecast demand.

- However, the costs that the ACCC is not allowing Telstra to recover are real costs. The adjustments are directly inconsistent with the ACCC's own Fixed Principles and the legislative criteria – the ACCC is arbitrarily removing costs that are efficient and that it has recognised that Telstra needs to incur to support the ongoing operation of the fixed line network and to continue to supply the fixed line services to those users that remain on the legacy network over the regulatory period.

- Telstra did not recover and had no opportunity to recover the costs that the ACCC proposes to remove from NBN Co or the Government. The payments Telstra receives from NBN Co occur and relate to compensation for the period after customers disconnect from Telstra's network. Those payments do not relate to the costs the ACCC has estimated for the supply of regulated fixed line services. The payments do not reflect any allowance for a loss of economies (on the legacy network) associated with the migration of customers to the NBN.

- The ACCC's justification for this adjustment is incorrect – Telstra did not cause the loss of economies of scale associated with the NBN migration and prices will not reach high levels in the absence of this adjustment (the ACCC's own modelling indicates prices only need to increase by 5.5% in nominal terms over a four year period, without the allocation

[3] Further Draft Decision, p 11.
[4] These individual impacts do not add to the overall impact of [redacted] due to rounding.

adjustment). In real terms, this would represent a reduction in current prices of 4% by FY2019.

- The ACCC's treatment of underutilised assets as a 'disposal' incorrectly interprets Australian Accounting Standards, and is directly inconsistent with standard Australian accounting and regulatory practice.

- The manner in which the ACCC has calculated the adjustment means the resulting prices are now based on hypothetical costs rather than Telstra's real costs – the resultant prices are based on a hypothetical scenario where Telstra is assumed to have much higher demand than it does under any realistic scenario (indeed, if the ACCC were to properly consider the hypothetical scenario in which Telstra did not enter into the Definitive Agreements with the Government and NBN Co, the prices for access seekers would likely be materially *higher* than will occur under current conditions).

- The proposed adjustment will negatively impact the broader industry and the migration to the NBN by distorting the incentives of access seekers to efficiently migrate to the new network and raises the risk of "sticker shock" for end users undertaking this migration. As noted earlier, in real terms the ACCC's proposal would result in a price decrease of more than 18% by FY2019. This is clearly inconsistent with an objective of price stability to facilitate a smooth industry migration to the NBN.

Further, if the ACCC's approach is a response to the loss of economies of scale evident in the 5.5% price increase, then it is difficult to see why the ACCC would adopt an approach that results in a 9.6% price reduction rather than prices that remain at current levels. This confirms that the ACCC's allocation and disposal adjustments take out more of Telstra's costs than the ACCC justifies by loss of economies of scale.

Whilst Telstra maintains a number of concerns with other parts of the Further Draft Decision (such as the inappropriate disposal of assets), as well as issues that have not been addressed in this Further Draft Decision (such as the estimation of the cost of capital), it is the new and unexpected adjustments – that were not contemplated by the Fixed Principles and that are inconsistent with both them and the legislative criteria – that are the focus of the remainder of this submission. Telstra also provides additional responses to specific queries raised by the ACCC with respect to its forecast costs.

1. NBN impacts and loss of economies of scale

1.1 The proposed NBN adjustments

The ACCC states in the Further Draft Decision that costs associated with NBN-induced loss of scale economies should not be reflected in regulated revenues.[5] The ACCC considers that these costs are caused by the migration of services to the NBN and not by users of the fixed line services. The effect of the decision would be to transfer these costs from wholesale customers to other users of the legacy network, notably Telstra retail users.

The ACCC appears to justify this outcome on the basis that Telstra had the opportunity to ensure that it received consideration for the impacts of the NBN through the Definitive Agreements, including in respect of the costs associated with the loss of economies of scale and asset redundancy. The ACCC considers that Telstra had significant bargaining power in those negotiations, which could have been used to extract this compensation. Further, the ACCC makes the unsubstantiated claim that, in the absence of these adjustments, prices could reach "absurd" levels.

To account for the supposedly NBN-induced loss of scale economies, the ACCC's Further Draft Decision is to make the following adjustments in the FLSM:

- A proportion of the regulatory value of assets made "redundant" by NBN migration is treated as an asset disposal in the roll-forward of the RAB. This proportion is determined based on the forecast of the rate of NBN rollout (**Disposals Adjustment**).

- For assets that become progressively under-utilised as a result of NBN migration, adjustments are made to remove relevant costs (including capital costs, operating costs and tax costs) on the basis of removing "loss of economies of scale" caused by the migration of end users to the NBN from regulated charges. The ACCC's approach characterises the change in unit costs as a different or new type of 'cost' that is capable of being separately calculated and then allocated. It quantifies the value of this new cost as being the proportionate difference between unit costs calculated by the FLSM and an estimate of unit costs that would result under a hypothetical scenario in which NBN-induced under-utilisation did not occur. It then allocates all of this new cost to Telstra by scaling down allocation factors for each asset class by this difference (**Allocation Adjustment**).[6]

At the outset, if the ACCC's concern is that users should not pay for the effects of loss of economies of scale, their model produces odd results. Without the Allocation Adjustment, the ACCC's model produces prices that would increase overall by 5.5% in nominal terms, (amounting to a **reduction** in current prices of 4% over the regulatory period). This does reflect some forecast loss of economies of scale, but with limited impact on pricing given Telstra's reduction in costs over the period.

By contrast, the ACCC's approach to removing the effect of lost economies of scale does not result in no change to current prices, as one would expect. Rather, it results in a 9.6% nominal drop in prices. This suggests that the ACCC's methodology does much more than remove the observed effects of loss of economies of scale.

In fact, the ACCC's methodology involves hypothesising a world in which the NBN does not exist (but where Telstra's capital and operating costs have already reduced to current levels), and then seeking to adjust for the difference between unit costs in the real world and this "without-NBN" hypothetical world. The objective appears to be to ensure that access prices reflect the unit cost of supplying services in a hypothetical "without-NBN" world, rather than unit costs in the real world.

[5] Further Draft Decision, p 11.
[6] Further Draft Decision, pp 73-74.

A fundamental problem with the ACCC's approach is that it uses the concept of "unit costs" to attempt to characterise a problem caused by falling demand as one of increasing costs. ACCC Chairman, Rod Sims, expressed the ACCC's rationale when announcing the further draft decision:[7]

> *"Users of Telstra's network should not pay the higher costs that result from fewer customers as NBN migration occurs. If there is no adjustment for these higher costs then customers who have not been migrated to the NBN will pay significantly higher prices for copper based services. Eventually these prices would reach absurd levels for the unlucky last copper customers,"*

In fact, there is no increase in costs. To the contrary, both Telstra's operating and capital expenditure *fall* over the regulatory period. Telstra's existing capital base and forecast expenditure are also efficient, as acknowledged by the ACCC in the Further Draft Decision. That is to say, Telstra needs to undertake this expenditure in order for it to continue to supply the fixed services to remaining users.

The ACCC has simply not identified any new or additional category of "higher costs" for which a different allocation principle is warranted. The ACCC's concern is about the *share of costs* that must be borne by each user as migration occurs. Despite the description above, the ACCC's model does not allocate a new form of cost to Telstra, but rather the ACCC seeks to apply a new allocation rule (which contravenes the Fixed Principles) to disallow Telstra the opportunity to recover the costs that the ACCC has otherwise accepted are forecast to be efficiently incurred. The justification used by the ACCC for not allowing Telstra to recover its (falling) costs of operating the network is that the ACCC is concerned that the prices that would need to be paid by remaining users (to cover their share of costs) are too high.

The effect of these adjustments is significant. The ACCC has calculated the total revenue requirement for the declared fixed line services for the FY2016-19 period to be [redacted] based on its assessment of Telstra's efficient costs.[8] The combined effect of the Disposals Adjustment and the Allocation Adjustment is to reduce the revenue requirement by [redacted] to [redacted][9] This combined effect can be broken into the following:

- The incorrect accounting treatment of redundant assets as disposals leads to a [redacted] reduction in the RAB value and a [redacted] reduction in the revenue that may be recovered from the declared fixed-line services over the period FY2016-19.

- The adjustment to cost allocation factors leads to [redacted] reduction in the revenue that may be recovered from the declared fixed-line services over the period FY2016-19 (across all fixed services, the implicit reduction in Telstra's allowed recoverable revenue is more than [redacted] over the forecast period).

The total disallowance of approximately [redacted] includes:

- approximately [redacted] prudent and efficient operating expenditure, which the ACCC has found to be necessary for the efficient operation of the fixed-line network;

- approximately [redacted] in tax costs; and

- approximately [redacted] in capital costs (including the return on and return of capital).

[7] ACCC Media Release, ACCC draft Fixed Line Services decision sees one-off uniform fall in access prices of 9.6%, 29 June 2015.
[8] ACCC FLSM (without NBN scale adjustment and disposals adjustment applied), 'Service Prices' sheet, cell F86.
[9] ACCC FLSM (with NBN scale adjustment and disposals adjustment applied), 'Service Prices' sheet, cell F86.

In effect, the ACCC's decision is to apply adjustments that remove approximately [redacted] of the revenue requirement calculated by its building block model and deny Telstra the ability to recover this amount from the provision of fixed-line services.

As discussed below, these adjustments raise a number of problems. The ACCC's approach:

- wrongly characterises "unit costs" as a different category of cost that is capable of being separately calculated and allocated;
- is justified on the basis of concerns about increasing or "absurd" prices which do not appear to be justified by the ACCC's own modelling;
- will lead to Telstra not recovering its efficient costs of supplying the declared services;
- breaches the Fixed Principles, which were established to provide parties with certainty about the regulated asset base and how the associated costs are recovered from different users of those assets;
- produces outcomes which harm and discourage the migration to NBN – while ultimately Telstra has an obligation to disconnect copper customers, end users and wholesale customers would greatly benefit under the draft prices if they frustrate and delay the migration process; and
- would require NBN to reduce its wholesale prices to avoid a large price shock as RSPs shift from copper wholesale prices and relatively high margins to NBN wholesale prices and relatively low margins.

1.2 The proposed NBN adjustments will lead to Telstra not recovering its costs

As a result of the Disposals Adjustment and the Allocation Adjustment, the amount of revenue that Telstra may earn from the supply of declared services is adjusted below what is required to recover the efficient cost of supplying the declared fixed-line services.

This is most apparent in relation to the Allocation Adjustment. As can be seen from the version of the ACCC's FLSM provided with the Further Draft Decision, the effect of the Allocation Adjustment is to reduce allowable revenue by [redacted] below what is required to recover the efficient costs of supplying declared services. As can be seen from the ACCC's FLSM:

- the ACCC calculates the efficient cost of supplying the declared services over the FY2016-19 period to be [redacted] (after making the Disposals Adjustment); <u>but</u>
- due to the Allocation Adjustment, Telstra is only allowed to recover [redacted] over the FY2016-19 period from the supply of declared services.

A comparison between the revenue requirement for each service (as calculated by the ACCC, with the Disposals Adjustment) and the amount allowed to be recovered is set out in Table 1 below.

Table 1: FLSM revenue allowance, with and without Allocation Adjustment ($2009, million)[10]

Service	Revenue requirement without Allocation Adjustment	Revenue requirement with Allocation Adjustment
Unconditioned Local Loop Service Band 1-3	[redacted]	[redacted]
Unconditioned Local Loop Service Band 4	[redacted]	[redacted]
Wholesale Line Rental	[redacted]	[redacted]
Fixed Originating & Terminating Access Service	[redacted]	[redacted]
Local Carriage Service	[redacted]	[redacted]
Line Sharing Service	[redacted]	[redacted]
Wholesale ADSL	[redacted]	[redacted]
Total	[redacted]	[redacted]

A breakdown of the revenue disallowance due to the Allocation Adjustment is set out in Table 2 below. This show that more than 70% of the impact from the Allocation Adjustment is due to the removal of operating expenditure and capital costs (return on capital and depreciation) related to capital deployed from 2009/10 onwards (i.e. after the establishment of the initial RAB in July 2011). More than a third of the impact is due solely to disallowance of operating expenditure.

Table 2: Breakdown of revenue disallowance due to Allocation Adjustment ($million, nominal)

	FY2016	FY2017	FY2018	FY2019	Total
New (opex and new capital)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Operating expenditure	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
New capital costs (return on and of capital deployed since 2009/10)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Legacy capital costs (initial RAB)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Tax	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[10] ACCC FLSM, table B.3.4 (with and without 'NBN scale adjustment' applied).

A further illustration of the effect of the Allocation Adjustment is provided in Table 3 for LSS. As can be seen, a significant proportion of the costs of providing LSS are rendered unrecoverable under the ACCC's approach. By FY2019, more that 50% of the costs of providing LSS would be unrecoverable, if the ACCC's Allocation Adjustment were to be applied.

Table 3: LSS costs not allowed to be recovered due to allocation adjustments ($2009, million)[11]

	FY2015	FY2016	FY2017	FY2018	FY2019
Direct costs of providing LSS (as determined by ACCC)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Costs allowed to be recovered	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Unrecoverable direct costs	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The effect of the Disposals Adjustment is a [redacted] reduction in the RAB value and a further [redacted] reduction in the revenue that may be recovered from the declared fixed-line services over the period FY2016-19

Thus, the Allocation Adjustment and Disposals Adjustment lead to a disallowance of approximately [redacted] over the period FY2016-19, including:

- approximately [redacted] in prudent and efficient operating expenditure, which the ACCC has found to be necessary for the efficient operation of the fixed-line network;
- approximately [redacted] tax costs; and
- approximately [redacted] in capital costs (including the return on and return of capital).

Such an approach is contrary to the long-term interests of end-users (**LTIE**). If Telstra is deprived of a reasonable opportunity to recover the efficient costs it incurs in supplying regulated services, this will not promote efficient competition, nor will it support efficient investment.

The ACCC has recognised that ongoing investment in the fixed-line network is necessary to support the supply of fixed-line services. The ACCC has approved a significant amount of new capital expenditure, as set out in Table 4 below. This includes significant new investment in data equipment and transmission equipment to support the growth in demand for bandwidth-hungry services.

Table 4: ACCC-approved forecast capital expenditure ($2009, million)[12]

	FY2015	FY2016	FY2017	FY2018	FY2019
CAN asset classes	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Core asset classes	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[11] ACCC FLSM, table 7.2.1.
[12] ACCC FLSM, table 3.2.

	FY2015	FY2016	FY2017	FY2018	FY2019
Total	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

However, the effect of the proposed Allocation Adjustment is that Telstra will not receive an appropriate return on this planned investment. The ACCC's position is thus internally inconsistent and unreasonable. The effect of the ACCC's adjustments is to scale down the allowance for all building block cost items, including the return on and return of capital. Therefore the ACCC's adjustment to cost allocation factors may lead to a level of investment that is below what the ACCC has approved as being efficient and in the LTIE.

The Allocation Adjustment will also not lead to an outcome that promotes efficient competition. The ACCC's adjustments will lead to access prices that are below the efficient unit cost of supplying the declared services. While such an outcome may promote the interests of particular competitors (in this case, access seekers), it will not promote efficient competition. It is widely acknowledged that the objective of promoting competition is not about increasing the number of competitors.[13] Rather, what is required to promote this objective is to provide appropriate conditions for each potential competitor to compete on their own merits (i.e. based on relative efficiency). Telstra considers that this is best achieved by ensuring that access seekers face the efficient cost of supplying the declared services, and not an artificially depressed access price.

1.3 The proposed NBN adjustments breach the Fixed Principles

The ACCC's proposed adjustments to remove costs required to support the fixed line network and supply the fixed line services on the basis that the recovery of these costs is impacted by NBN-induced loss of scale economies are fundamentally inconsistent with the Fixed Principles established by the ACCC.

The Fixed Principles establish a building block framework for determining prices. Under this framework, prices are set so as to recover the efficient cost of supplying the declared services using Telstra's fixed line network, based on a clear set of rules as to how relevant assets are valued, forecast costs are to be assessed and costs allocated.

It is important to step through the interactions of the individual Fixed Principles:

- By locking in the initial RAB value, the ACCC does and acknowledges two things. First, that the assets used to supply the fixed line services have an agreed initial value (as at the commencement of the BBM regime). Second, that the assets encapsulated within that value represent <u>Telstra's actual network</u>.

- By locking in the value of the network (and, implicitly, acknowledging the real-world network that is represented by the valuation) the RAB Fixed Principle frames any assessment of the efficiency and prudency of new capital expenditure. In other words, the ACCC is required to assess whether or not Telstra's forecast capital expenditure is prudent and efficient in the context of the network Telstra operates and that is encapsulated by the RAB. This occurs once – at the time that costs are included in the RAB.

- The assessment of efficient operating costs is similarly based on the network reflected in the RAB (Telstra's actual network) – the ACCC cannot assess the prudency of operating costs on the basis of a different (hypothetical) network structure, different to that reflected in the RAB.

[13] *Re Telstra Corporation Ltd (No 3)* [2007] ACompT 3, [99]; *Sydney International Airport* [2000] ACompT 1, [108]; *Sydney Services Pty Limited* [2005] ACompT 7, [136].

- In allocating costs among network users, the Fixed Principles require the ACCC to assess actual demand for actual services supplied using the actual network. This is critical, as it ensures that prices set for declared services are based on a set of costs (the numerator) and demand information (the denominator) that reflects the real world network that Telstra operates and the real world conditions in which it operates. The Fixed Principles require demand to reflect the best and most up-to-date information about what is *actually* forecast to occur.

- The ACCC cannot invent a new numerator (i.e. based on the hypothetical costs that would be faced to operate a hypothetical network) and equally the ACCC cannot apply a denominator based on a hypothetical level of demand. Clearly, if either the numerator *or* the denominator is allowed to represent hypothetical values rather than actual, real-world values, then the entire object of the Fixed Principles is breached.

Given the above, it would be inconsistent with this well-established framework for the ACCC to adjust for "loss of economies of scale" resulting from the migration of customers to the NBN. The costs the ACCC is seeking to remove are not caused by the NBN. On the contrary, the ACCC is seeking to remove operating costs, capital costs and tax allowances that it accepts as being required to support the provision of the declared fixed line services, and which are caused by current users of the network.

There is an inherent unreasonableness and inconsistency in the ACCC's approach. On one hand the ACCC accepts that a certain amount of cost is necessary to operate the fixed-line network and maintain the supply of declared services, yet on the other hand the ACCC has determined that a portion of this cost cannot be recovered from declared service charges.

There is also an inconsistency in how the ACCC determines the various BBM inputs. While purporting to apply a BBM approach, which is intended to compensate the service provider for the efficient cost of operating the existing network, the ACCC:

- removes certain assets from the RAB on the basis that they are (or are expected to be) obsolete or redundant; and

- assumes away large amounts of operating expenditure, resulting in an expenditure allowance that does not reflect (and is materially less than) the cost of operating the existing network.

The ACCC seeks to effectively optimise the scale of the network and associated operating costs. This is clearly inconsistent with its adoption of a BBM pricing approach.

1.3.1 The purpose of the Fixed Principles

The ACCC adopted a building block model (**BBM**), and committed to applying it consistently by implementing it through Fixed Principles, to overcome uncertainty and unpredictability which had resulted from the periodic 'optimisation' of the asset base as part of each price review. The ACCC observed that the continual revaluation of network assets under TSLRIC+ meant that there had been ongoing uncertainty over the level of access prices.[14] Therefore a key reason for moving to a building block model approach was to improve certainty for both the access provider and access seekers.[15] The ACCC sought to provide further certainty as to how the building block model approach would be implemented, by codifying certain aspects of the methodology.[16]

[14] ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services: Draft report*, September 2010, p 15.
[15] ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services: Draft report*, September 2010, p 18.
[16] ACCC, *Public inquiry to make final access determinations for the declared fixed line services: Discussion paper*, April 2011, pp 252-253.

In short, the primary benefit of adopting and 'locking in' a BBM was that it moved fixed services pricing away from being based on hypothetical costs, and ensured prices would be determined based on actual historic costs (together with any prudent forecasts costs) and the best available view of demand.

The approach now being adopted is not only inconsistent with the Fixed Principles, it is also antithetical to the intent of the building block method and the ACCC's reasons for adopting this method in 2010. It replaces actual costs with hypothetical costs and the best view of demand with a 'counterfactual' (non-NBN) demand assumption that is known, at the time it is being used, to be inaccurate and wrong.

In deciding to adopt a building block method, the ACCC observed that:[17]

> *The ACCC considers that the BBM pricing approach meets the objective of ensuring that the access provider is adequately compensated for its costs over time. As noted above, the BBM calculates the revenue required to cover the access provider's efficient costs, including a commercial return on investments. This is also consistent with the general regulatory principle that a regulated business should expect to receive sufficient revenue to allow it to cover all expected prudent expenditure necessary to maintain a given level of service at each period into the future.*

If the ACCC were to exclude certain efficiently incurred costs from the determination of prices, this would undermine the stated objectives of the BBM approach. In particular, this would be in direct conflict with the objective of ensuring that the access provider is adequately compensated for the efficient costs it incurs in supplying regulated services.

It would similarly be inconsistent with this framework for the ACCC to base pricing on what Telstra's costs would be in a hypothetical "without-NBN" world. Under a building block model, prices are not set so as to reflect costs in an alternative hypothetical world. Rather, prices are set so as to reflect the efficient costs faced by the service provider in supplying the regulated services.

It should be noted that the building block model was adopted, and the Fixed Principles codified, in full knowledge of the NBN policy. The Fixed Principles were first included in the FADs in July 2011, by which time the NBN policy was well developed and the June 2011 Definitive Agreements between Telstra, NBN Co and the Commonwealth had been signed.[18] It cannot be said that some exception to the Fixed Principles needs to be made for 'NBN impacts'.

To the contrary, the ACCC at the time of introducing the BBM noted the importance to industry of greater certainty and predictability in the setting of regulated prices during the NBN rollout period.[19] Far from being a basis for revisiting or departing from the BBM – the NBN rollout was a key justification for moving to the BBM from the former TSLRIC+ regime, and for locking this new model in place over the next decade through Fixed Principles.

1.3.2 Consistently applying the Fixed Principles will promote the LTIE

The ACCC determined in the 2011 FADs that it was in the LTIE to adopt the cost-based methodology that is reflected in the Fixed Principles – i.e. a building block pricing method – and to lock-in this method for a period of ten years through the use of Fixed Principles.

[17] ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services: Draft report*, September 2010, p 18.
[18] 'Telstra signs NBN Definitive Agreements', media release, 23 June 2011.
[19] ACCC, *Public inquiry to make final access determinations for the declared fixed line services: Discussion paper*, April 2011, pp 252-253.

The ACCC considered that a key benefit of the Fixed Principles is that they would provide certainty as to how prices would be determined in future regulatory periods. The ACCC stated:[20]

> *The fixed principles provisions proposed in this discussion paper would provide certainty over time for industry participants on the pricing framework used by the ACCC to implement a BBM approach to estimating prices for the declared fixed line services. A major rational for moving to a BBM approach was to improve pricing certainty for all industry participants…*
>
> *The ACCC is of the view that including fixed principles provisions in the FADs will provide certainty about how the ACCC will estimate prices for the declared fixed line services after the end of the proposed five-year regulatory period in 2016. Certainty over time on the pricing framework will assist industry participants in their business and investment planning during the transition to the NBN.*
>
> *The ACCC considers that the provisions proposed in this discussion paper will promote regulatory certainty by ensuring that the BBM approach will be implemented consistently and predictably in future regulatory periods. Further, the ACCC considers that the proposed fixed principles provisions are likely to reduce the regulatory burden and the time required to conduct price resets by removing the need to review all aspects of the pricing framework at every price reset.*

The Further Draft Decision is a significant departure from this approach. Having informed Telstra and the market in 2011 that the ACCC's approach was to provide certainty about how it would proceed at the end of the regulatory period in 2016 (including because of the impact of the NBN rollout), the ACCC is now undermining that certainty by adopting an entirely different method of dealing with costs than was adopted in 2011 and seeking to justify doing so on the basis of the NBN rollout. It is a method that has never been proposed or discussed at any time since. There has been no opportunity for Telstra or others in the market to respond or adapt to the change. After a two-year FAD process, Telstra and industry have been given three weeks to respond to this radical departure from, and contravention of, the Fixed Principles. The proposed FAD outcome would create the very uncertainty that the ACCC has represented for the last five years has been its policy to avoid.

As discussed further below, the approach that has been proposed by the ACCC is clearly and unambiguously inconsistent with the Fixed Principles and will not promote the LTIE. Such an approach undermines the regulatory certainty and predictability that is provided for by the Fixed Principles.

Telstra considers that the LTIE will be promoted by the ACCC adhering to the Fixed Principles that it established in 2011 and, by making them fixed principles, committed under the *Competition and Consumer Act 2010* (**CCA**) to apply and not vary over the period to 2021.

1.3.3 Requirement to comply with the Fixed Principles

The fixed principles provisions in Part XIC of the CCA were introduced in 2011, and were intended to allow the ACCC to "lock in" certain aspects of its determination over multiple determination periods. The express intent of these provisions was to allow the ACCC to provide greater regulatory certainty.

Section 152BCD(1) of the CCA provides that an access determination "*may include a provision that is specified in the determination to be a fixed principles provision*". The meaning of the words in this provision, and hence the intention of the legislature, is clear. "Fixed" embodies firmness, permanence and stability. It is not a word capable of ambiguity. "Principle" embodies a rule, a tenet, or a requirement. It must be presumed that the statutory draftsperson used the words for

[20] ACCC, *Public inquiry to make final access determinations for the declared fixed line services: Discussion paper*, April 2011, pp 252-253.

good reason, and the reason was to make it clear that the fixed principles are rules, tenets or requirements that are not to be changed other than in accordance with the CCA.

This is reinforced by other sub-sections of s 152BCD:

- A fixed principles provision must have an end date (that is, a date beyond which they no longer apply).

- Unexpired fixed principles must be incorporated into any access determination that replaces the determination in which the fixed principles were made.

- A determination in which fixed principles are made must state that the principles cannot be varied.

None of these provisions would be required if the fixed principles did not have effect, or if they did not have to be complied with.[21] The only reason the draftsperson could have had for including them is to ensure that the fixed principles no longer have effect after their expiry date, and remain in effect until their expiry date, even if the determination otherwise changes.

There is no doubt that the intention of the legislature was to require fixed principles to have effect. Indeed, the Explanatory Memorandum to the bill introducing these provisions stated:[22]

> *The effect of specifying that a provision is a fixed principles provision is to "lock in" the matters dealt with in that provision until a particular date…*
>
> *By enabling the ACCC to lock in provisions contained in an access determination for a specified period (which may be longer than the duration of the access determination in which the provisions are contained), proposed section 152BCD will enable the ACCC to provide greater regulatory certainty in certain circumstances. For example, where the ACCC adopts a utility pricing model for setting the access price for a declared service - with all price determinations during the economic life of the relevant facility based on a regulated asset base - the ACCC will be able to lock in a regulated asset base for the requisite period.*

Accordingly, the ACCC does not have the power to make a decision that departs from the Fixed Principles. To the extent that the ACCC purports to do so, its decision will be ultra vires.

As noted above, one of the key reasons given by the ACCC for moving to a building block methodology, and locking in this methodology through the Fixed Principles, was that it would provide greater certainty for the access provider and access seekers.[23] The ACCC noted in particular that continual revaluation of assets under the previous TSLRIC+ regime had led to ongoing uncertainty over the level of access prices. The ACCC therefore sought to provide longer term certainty by locking in certain matters – including the value of the RAB and the pricing methodology – through the Fixed Principles.

As a matter of law, matters relating to pricing methodology have already been determined and locked in through the Fixed Principles. It is not open to the ACCC to seek to revisit or vary matters of pricing methodology in making replacement FADs, to the extent that these methodological matters are addressed by the Fixed Principles.

---

[21] It is a well-established principle of statutory interpretation that the courts are not at liberty to consider that any word or provision is superfluous or insignificant. See, for example: *Project Blue Sky Inc v Australian Broadcasting Authority* [1998] HCA 28.

[22] Explanatory Memorandum to the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009.

[23] ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services: Draft report, September 2010, pp 15-18.

1.3.4 Breach of the RAB roll-forward Fixed Principle

The ACCC's removal of "redundant" assets from the RAB is inconsistent with the RAB roll-forward Fixed Principle (clause 6.7(a) of the Fixed Principles).

Clause 6.7(a) states:

> *(a) The RAB is to be rolled forward each year according to the formula below:*
>
> $RAB_{t+1} = RAB_t + capex_t - depreciation_t - asset\ disposals_t$
>
> *where* RAB_{t+1} *= opening RAB for the next regulatory year*
>
> RAB_t *= opening RAB for the current year*
>
> $capex_t$ *= forecast capital expenditure during the current year*
>
> $depreciation_t$ *= regulatory depreciation during the current year*
>
> $asset\ disposals_t$ *= asset disposals during the current year*

This provision is prescriptive as to the method for rolling forward the RAB. Only the adjustments identified in that provision – for new capital expenditure, depreciation and asset disposals – are to be made. No other adjustment, such as for "redundant" or under-utilised assets, may be made.

The ACCC seeks to justify its adjustment for "redundant" assets on the basis that it treats these assets as "disposals". This is simply incorrect, and reflects a misunderstanding of the accounting standards referred to in the Further Draft Decision. It is also inconsistent with regulatory practice and the plain meaning of the term 'asset disposal' – which requires a *disposal* to occur. Redundant assets are not "asset disposals" unless (and until) they are transferred to a third party. Assets that become obsolete are treated, in accounting practice, as asset *retirements*.

The asset disposals mechanism is not a tool validly available to the ACCC to otherwise "delete" assets from the RAB (including by ex post optimisation of the RAB). Rather, the asset disposals mechanism is designed to address situations where an asset has been transferred to a third party, and the access provider no longer has ownership or effective control over it (and therefore no longer bears the cost of holding the asset). The Fixed Principles are intended to provide certainty as to the value of assets, and to treat "asset disposals" as a broad category of means with which to delete assets within and between regulatory periods undermines that purpose.

As explained in Telstra's submission in response to the March draft decision, the term 'asset disposal' has a well understood meaning, both in accounting and in regulatory economics.[24] In both of these contexts, the term refers to a transfer of an asset, not merely its reduced use. Both those fields clearly define depreciation as the means with which to treat the reduced use of an asset.

In a further report in response to the Further Draft Decision, Mr Keith Lockey explains that the ACCC's interpretation of the relevant accounting standards in relation to asset disposal is incorrect.[25] Mr Lockey explains that the ACCC's treatment of assets that are made redundant by NBN migration but remain under Telstra's ownership and control as disposals is inconsistent with Australian Accounting Standards. Mr Lockey states:[26]

---

[24] Telstra submission in response to the Draft Decision, 1 May 2015, p 39.
[25] KPMG, Independent advice on the basis of accounting for disposal of assets in Telstra's regulatory asset base for fixed line services, July 2015.
[26] KPMG, Independent advice on the basis of accounting for disposal of assets in Telstra's regulatory asset base for fixed line services, July 2015, p 4 (Attachment 5).

> *…the ACCC's view… that commercial obsolescence is a relevant factor in determining whether an asset has been disposed of, is inconsistent with Accounting Standards. Commercial obsolescence is relevant to the derecognition of value through impairment or depreciation, but it does not fall within the ambit of a disposal under Accounting Standards.*
>
> *In particular, the view… that a disposal transaction is incidental to determining whether an asset is disposed, contradicts Accounting Standards. A disposal transaction is necessary for a disposal.*

Mr Balchin expresses a similar view from a regulatory economics perspective. In a report that was submitted with Telstra's response to the March draft decision, Mr Balchin states that the "core ingredient" for a disposal is that there has been a transaction in relation to the assets in question and, as a consequence, an alternative avenue for the recovery of any remaining cost associated with that asset.[27] Mr Balchin affirms this view in his further report in response to the Further Draft Decision.[28]

The ACCC's interpretation of the word "disposal" is also inconsistent with its common and ordinary meaning. The common and ordinary meaning of a disposal is where something is transferred or "gotten rid of". For example the Oxford dictionary definition of the term "disposal" is "the action or process of getting rid of something".[29] Similarly, the Oxford dictionary definition of the term "dispose of" is: "get rid of by throwing away or giving or selling to someone else".[30] These definitions do not refer to something simply becoming under-utilised or redundant. Rather, it involves some act of transfer or disposal.

Redundant assets that are not fully depreciated cannot be removed from the RAB under the Fixed Principles unless they are actually "disposed of", within the widely understood meaning of that term. Only assets that are properly disposed of or fully depreciated may be removed from the RAB under the Fixed Principles.

As previously explained, to the extent that there is any concern about customers continuing to pay for redundant assets in future, this can be addressed in accordance with the Fixed Principles by aligning the depreciation profile for those assets with their expected useful life.[31] This may involve accelerating depreciation on some assets that are expected to become redundant before they are fully depreciated. Of course, under the Fixed Principles any adjustments to the depreciation schedule should only affect the timing of capital cost recovery, not the total amount to be recovered – in other words, any adjustment should be NPV-neutral. Such adjustments are expressly contemplated in other regulatory regimes that utilise building block methodologies.[32]

1.3.5 Breach of the demand Fixed Principle

The ACCC's Allocation Adjustment is inconsistent with the demand Fixed Principle (clause 6.11 of the Fixed Principles).

Clause 6.11 states:

---

[27] Incenta, *Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services*, April 2015, p 3.
[28] Incenta, *Comment on the ACCC further draft decision in relation to fixed line services*, July 2015, p 18 (Attachment 4).
[29] Oxford dictionary online.
[30] Oxford dictionary online.
[31] Telstra, *Public inquiry into final access determinations for fixed line services—primary prices: Response to industry submissions*, 22 December 2014, p 15.
[32] For example, under the National Gas Rules (NGR), adjustments can be made to the depreciation schedule between access arrangement periods, provided that the depreciation schedule for any period meets certain criteria. The NGR also expressly contemplate that it may be appropriate to 'front-load' or 'back-load' depreciation in some circumstances (NGR, rule 89(2)).

6.11 Demand forecasts should:

(a) be based on an appropriate forecasting methodology;

(b) be based on reasonable assumptions about the key drivers of demand;

(c) be determined utilising the best available information before the ACCC, including historical data that can identify trends in demand; and

(d) be determined taking into account current demand and economic conditions.

This provision is clear that demand forecasts must reflect *current* demand and economic conditions. It does not allow for hypothetical or unrealistic forecasts of demand.

The ACCC's adjustments are not based on a realistic expectation of forecast demand. Rather, these adjustments are based on an entirely hypothetical view of what demand for fixed-line services would look like, *absent the NBN*. As explained by the ACCC, step one of its adjustment method involves estimating unit costs based on expenditure and demand forecasts that do not account for the impact of the NBN.[33]

Mr Balchin states:[34]

> *… 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... 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.*
>
> *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.*

As set out above, using hypothetical demand is equivalent in its effects to using hypothetical costs. It invalidates not only the demand Fixed Principle, but also the application of the remaining Fixed Principles.

1.3.6 Breach of the cost allocation Fixed Principle

The ACCC's Allocation Adjustment is also inconsistent with the cost allocation Fixed Principle (clause 6.14 of the Fixed Principles).

Clause 6.14 states:

> *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.*

[33] Further Draft Decision, p 73.
[34] Incenta, *Comment on the ACCC further draft decision in relation to fixed line services*, July 2015, pp 12-13 (Attachment 4).

(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.

It is plainly apparent that the ACCC's overlay adjustment leads to an allocation of costs that does not reflect the relative usage of the network by various services or the causal relationships between supplying (fixed line) services and incurring costs. Due to these adjustments, the allocation of costs to declared fixed-line services is materially lower than the relative usage of the network by these services. This is because a portion of the total cost base is effectively assumed away for the purposes of this adjustment.

An example of this is shown in Table 5 below. This shows that, by FY2019, ULLS is expected to account for approximately 26.4% of total access lines. However, under the ACCC's approach, only 23.3% of the revenue requirement for copper cables is allocated to the ULLS.

Table 5: Comparison of allocation of copper cable cost to ULLS with relative network usage by ULLS[35]

	FY2015	FY2016	FY2017	FY2018	FY2019
Copper cables costs allocated to ULLS					
Costs allocated to ULLS	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Revenue requirement	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Share allocated to ULLS	***16.1%***	***17.8%***	***19.6%***	***21.4%***	***23.3%***
ULLS share of total lines					
ULLS lines	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total access lines requirement	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
ULLS share of total lines	***17.9%***	***19.9%***	***21.9%***	***24.1%***	***26.4%***

This result arises due to the two-step approach adopted by the ACCC to allocation of costs in the Further Draft Decision. The ACCC first incorporates a fully allocated cost framework in its FLSM, but then makes an adjustment to this allocation framework to remove the effect of 'NBN-induced loss of economies of scale'. The result is a set of allocators that does not provide for full allocation of the revenue requirement among users of the fixed-line network.

The effect of what the ACCC proposes is a reversion to a 'partial allocation approach', the approach that it rejected in the March draft decision. The effect of the ACCC's adjustments to the FLSM cost allocators is that a portion of the total revenue requirement (i.e. the portion that the ACCC attributes to NBN-induced loss of scale economies) is not allocated across current users of

[35] Cost allocations taken from ACCC FLSM (with NBN scale adjustment applied), '7. Service Costs' sheet, table 7.3.1. Demand taken from ACCC FLSM, '5. Service Demand' sheet, table 5.1.1 and 'NBN Scale Adjustments' sheet, row 446.

the fixed-line network. This portion of the revenue requirement is effectively assumed away, and is not allocated to any current user or service.

This is despite the ACCC stating in the March draft decision that the partial allocation approach (as adopted in the 2011 and 2013 FADs) may lead to Telstra not recovering its costs. The ACCC stated:[36]

> *The ACCC considers that the 2011 partial cost allocation approach may not allow sufficient opportunity for full cost recovery of the declared services' share of fixed line costs, and that in some circumstances, Telstra may be prevented from recovering these costs by a significant amount. The ACCC considers a fully allocated framework is preferred to alternatives for the purposes of accounting for NBN Co's use of Telstra's fixed line assets. In particular, applying demand adjustments to cost allocation factors, as was done for the 2011 FADs, would mean that more precise information on NBN Co's use of assets would be excluded from consideration; would be unlikely to accurately reflect the impact of NBN Co's use of assets; and would be likely to result in Telstra under-recovering or over-recovering its efficient costs. Maintaining the cost allocation approach of the 2011 and 2013 FADs has similar limitations when accounting for assets that are transferred to NBN Co and assets that are decommissioned as a result of migration to the NBN.*

The ACCC also stated in the March draft decision that it considers that a fully allocated cost framework is most compatible with the building block framework and the Fixed Principles. The ACCC stated:[37]

> *The ACCC considers that a fully allocated cost framework is the most appropriate for allocating Telstra's fixed line network costs for a number of reasons.*
>
> *First, the ACCC considers that a fully allocated approach is the most compatible with the objectives of a building block approach to regulatory price setting. A key objective of the building block approach is to provide regulated entities with a reasonable opportunity to recover the efficient costs of investing in and operating assets used to provide regulated services. A fully allocated approach is consistent with this objective because all costs are explicitly allocated to all services that use particular assets. If costs are not fully allocated between all relevant services, the access provider cannot have an expectation it will be able to recover its efficient costs, and this is likely to discourage efficient investment in the fixed line network.*
>
> *Second, the ACCC considers that a fully allocated approach is likely to result in cost allocation factors that reflect the relative use of Telstra's fixed line assets by all services that use those assets. This will result in prices that reflect the relative cost of supplying those services and promote efficient use of and investment in infrastructure used to provide fixed line services. The ACCC recognised the importance of this in the fixed principles provisions included in the 2011 and 2013 FADs.*

Telstra agrees with the ACCC's conclusions in relation to the cost allocation framework in the March draft decision. A fully allocated cost framework is required in order to comply with the Fixed Principles and to provide Telstra with a reasonable opportunity to recover the cost of supplying the fixed-line services.

The ACCC states in the Further Draft Decision that it maintains its view that a fully allocated cost approach is appropriate, including because it is compatible with the building block methodology and is likely to result in prices that reflect the relative cost of supplying declared services.[38] However, the ACCC does not adopt a fully allocated cost framework. The ACCC instead adopts a

[36] ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, p 151.
[37] ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, pp 150-151.
[38] Further Draft Decision, p 81.

fundamentally different approach to that adopted in the March draft decision, which involves not allocating a significant portion of Telstra's cost base. While the ACCC starts with a fully allocated cost framework, it then makes a very significant adjustment which leads to the revenue requirement only being partially allocated. The ACCC does not explain how it reconciles this new approach with its stated preference for a fully allocated cost framework.

Telstra notes that one reason a fully allocated cost framework was not adopted in the 2011 and 2013 FADs is that there was insufficient information available to implement such an approach. As noted by the ACCC in the March draft decision, lack of information limited the choice of approach to cost allocation for the previous FADs.[39] However this is clearly no longer the case, as the ACCC now has before it: a fully allocated cost model (submitted to the ACCC in July 2014); detailed documentation explaining the assumptions and inputs underpinning this model; an expert review of the fully allocated cost model conducted by KPMG; and an expert review of the fully allocated cost model conducted by the ACCC's consultants, Analysys Mason. Therefore it can no longer be said that reliable information is not available to support the proper application of the cost allocation Fixed Principles.

Mr Balchin is clear in his view that the allocation of costs resulting from the ACCC's two-step method breaches the cost allocation Fixed Principle. Mr Balchin states:[40]

> *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.*
>
> *As I concluded in my first report, 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. 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.*

Mr Balchin concludes that the ACCC's allocation of costs is plainly inconsistent with clause 6.14 of the Fixed Principles.[41]

1.4 The ACCC's justification for the proposed adjustments is flawed

The ACCC's justification for the proposed NBN adjustments is as follows:

- there is a new form of "higher costs" associated with the loss of economies of scale caused by NBN migration and access seekers should not bear these costs, as they did not cause this;
- the loss of economies of scale is due to Telstra entering into commercial agreements with NBN Co to disconnect customers from its network. Since Telstra (at least partly) caused the loss of economies of scale through its agreements with NBN Co, the cost of any loss of economies of scale should be entirely borne by Telstra; and
- Telstra had an opportunity to ensure that it would receive consideration through the Definitive Agreements for the impact of the NBN on its fixed line network (including lost economies of scale).

[39] ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, p 151.
[40] Incenta, *Comment on the ACCC further draft decision in relation to fixed line services*, July 2015, pp 10-11 (Attachment 4).
[41] Incenta, *Comment on the ACCC further draft decision in relation to fixed line services*, July 2015, p 11 (Attachment 4).

These matters are both incorrect and not relevant to whether the proposed adjustments are consistent with the Fixed Principles. However they are nonetheless addressed below.

The ACCC also states, as a further justification for implementing the Allocation Adjustment, that not doing so would lead to prices reaching "absurd levels" for some access seekers.[42] This is not a conclusion warranted by the ACCC's modelling, which shows a fall in prices (in real terms) of approximately 4% over the period to FY19, without the Allocation Adjustment being made. In any event, even if there was some prospect of such an issue arising in subsequent periods, there are means of addressing it in accordance with the Fixed Principles, such as through changes to depreciation profiles.

1.4.1 The ACCC's focus on the cause of NBN impacts is misplaced

In the Further Draft Decision, the ACCC states:[43]

> *The ACCC considers that these costs [NBN-related loss of scale economies] are caused by the migration of services to the NBN and that they are not caused by users of the fixed line services. (page 11) … 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.*

As noted above, the loss of economies referred to by the ACCC is not a different or new category of 'costs'. A loss of economies simply means that, as the number of users falls, costs do not fall as quickly as demand meaning that more of the efficient cost of operating the network and supplying services needs to be allocated across fewer users. The relevant costs in this context remain the costs of operating and maintaining the common infrastructure comprising the fixed-line network. These costs are still jointly caused by all services that use the network, including the declared fixed-line services. Indeed, these are costs that the ACCC has approved, on the basis that they reflect the prudent and efficient cost of maintaining the fixed-line network and supplying declared services.

Therefore it is incorrect to say that there is a new category of "cost" that has been caused by NBN migration, or by any decision by Telstra to co-operate in the migration process. The costs under consideration have no connection with the NBN. They are the costs associated with the ongoing operation of the fixed-line network and the provision of services (including the declared services) over that network.

What the ACCC appears to be focusing on is what has caused the **decline in demand** associated with customer migration to the NBN. The ACCC appears to be concerned that this decline in demand may lead to an increase in unit costs if the total cost pool does not decline at the same rate.

Telstra considers that the ACCC's focus on the cause of this decline in demand is misplaced. Under a building block model, where an exogenous event occurs which alters demand (and therefore unit costs), there is no scope to ignore this on the basis of its cause (including whether or not users of the network were the cause).

In any event, the ultimate cause of the decline in demand for fixed-line services was a Government policy to deliver the NBN. While it is true that this event was not caused by access seekers (just as it was not caused by Telstra), this does not provide a basis for ignoring it in the determination of access prices under the ACCC's building block model.

---

[42] 'ACCC draft Fixed Line Services decision sees one-off uniform fall in access prices of 9.6%', media release, 29 June 2015.
[43] Further Draft Decision, p 11.

1.4.2 Telstra did not cause the loss of scale economies associated with NBN rollout

As explained in Telstra's submission in response to the March draft decision, Telstra is not responsible for the decline in demand due to NBN migration, nor is it compensated for the impact of any associated loss of economies of scale.[44] The fact that the NBN is being rolled out, and the expected impact of this on demand for fixed line services, is not due to any decision by Telstra. Rather, this flows from the implementation of the Government's NBN policy. Further, the payments to be received from NBN Co will not compensate Telstra for the effect of customer migration on the unit cost of supplying fixed line services.

The transition to the NBN that was initiated by Government policy is expected to benefit the entire industry. Since the transition is due to Government policy and not any action by Telstra, and since the entire industry is expected to benefit, it is appropriate that any impact of the transition on the cost of supplying fixed line services be shared proportionately among Telstra and access seekers. Adhering to the Fixed Principles would deliver this outcome. There is no reasonable or rational basis for suggesting that all participants in the market should share in the benefits of the migration to the NBN, but that only one of them – Telstra – should bear the burden of its impact, where this results in loss of economies of scale over the course of the migration.

1.4.3 Telstra's "opportunity" to negotiate recovering these costs separately through deal payments

The Further Draft Decision places emphasis on Telstra's <u>opportunity</u> to seek compensation for any effects of loss of economies of scale through the deal payment negotiations. The ACCC states:[45]

> *The ACCC considers that Telstra has been provided with an opportunity to ensure that it would receive consideration through the Definitive Agreements for the impact of the NBN on its fixed line assets. Telstra was aware that the disconnection of fixed line customers during NBN migration would cause asset redundancy and increasing asset under-utilisation, and that unit costs would rise as a result. The ACCC considers that Telstra possessed significant bargaining power in negotiations with NBN and the government—notably, if Telstra had not cooperated in the NBN rollout, NBN would have been required to bypass the fixed line network and unnecessarily duplicate costly infrastructure.*

The ACCC says that the sufficiency of the deal payments is irrelevant.[46]

The question of any opportunity to recover is also irrelevant. The question is whether in fact Telstra has recovered these costs through another means (e.g. disposals) – a point accepted by the ACCC's expert (Analysys Mason):[47]

> *We note that Telstra has presented arguments that it has not received any consideration for assets stranded as a result of the NBN. If those arguments were accepted it would be difficult to justify preventing Telstra from recovering the full costs of the regulated asset base (RAB), which is 'locked in' under the BBM approach with a fully allocated CAF.*

The Fixed Principles require allocation of costs on basis of relative usage of the network – based on the services to which they relate (and based on causal relationship between supply of the service and the costs). They do not allow for considering 'opportunity' to recover from another source.

---

[44] Telstra submission in response to the Draft Decision, 1 May 2015, pp 44-50.
[45] Further Draft Decision, p 73.
[46] Further Draft Decision, p 73.
[47] Analysys Mason, ***Assessment and verification of inputs into Telstra's Cost Allocation Framework***, 16 June 2015, p 6.

In any event, Telstra did not have the opportunity to recover these 'costs' (or to be compensated for the effect of declining demand on unit costs). Telstra was not able to achieve an outcome that fully compensated it for all of the impacts of NBN rollout. The outcome was demonstrably one in which Telstra lost value.

The ACCC asserts, in the passage quoted above, that Telstra possessed significant bargaining power in negotiations with NBN Co and the Government. The implication of this appears to be that Telstra would have had an opportunity to seek compensation for the effect of loss of economies of scale due to the NBN rollout.

A review of the history of the NBN policy development (Attachment 1) indicates that this assertion is not correct, and that several strong political and commercial factors constrained Telstra's bargaining power. These include:

- **Telstra participation was not required**. While Telstra may have had some bargaining power had its infrastructure been *required* for the NBN rollout (as it would have been under the original FTTN NBN), this was not the case by the time Telstra started negotiating the terms of its commercial arrangements with NBN Co and the Commonwealth in late 2009. By that time, it had been decided that the NBN would be rolled out as a FTTP network, meaning that Telstra's participation was not necessary. This was made clear by the Communications Minister, Senator Conroy, at the time. Senator Conroy stated that "*we will build the NBN with or without Telstra", "we are building the network irrespective of the outcome of the talks with Telstra",* and that "*if they [Telstra] want to compete with the network, then bring it on*".[48]

- **September 2009 legislative changes**. A number of legislative changes were passed in September 2009 which were designed to give Telstra a strong inducement to structurally separate and co-operate in the rollout of the NBN. If Telstra chose not to structurally separate, the legislation provided for the Government to impose a strong functional separation framework on Telstra. The legislation also provided that Telstra would be prevented from acquiring additional spectrum for advanced wireless broadband while it remained vertically integrated, owned a HFC network, and maintained its interest in Foxtel. This was described as "*putting a gun to Telstra to Telstra's head*"[49] and giving Telstra "*an offer it can't refuse*", to structurally separate and participate in the NBN rollout.[50]

These factors provided a very strong constraint on Telstra's negotiating position.

The attached statement of [redacted], explains the various constraints on Telstra's bargaining power in these negotiations. [redacted] explains:[51]

> [redacted]
>
> [redacted]

[48] John Durie, 'Senator Stephen Conroy won't delay NBN legislation for Telstra', *The Australian*, 14 October 2009.
[49] Senator The Hon Nick Minchin, *Telstra Should Not Buckle Under Labor's Threats* (media release), 30 September 2009.
[50] Malcolm Maiden, 'Offer Telstra couldn't refuse', *Sydney Morning Herald*, 16 September 2009.
[51] Statement of [redacted], July 2015, pp 2-3 (Attachment 7).

[redacted]

From the perspective of NBN Co and the Government, there was similarly no incentive or requirement for either party to compensate Telstra for all of the impacts of the NBN rollout, such as the potential for lost economies of scale. The policy decision to roll out the NBN had already been made and there was no reason for NBN Co or the Government to compensate Telstra for the effects of this decision.

The deal payments therefore do not compensate Telstra for costs associated with the NBN policy that would have occurred regardless of whether or not Telstra cooperated – including loss of economies of scale associated with migration to the NBN.

Telstra has also previously explained that it was not fully compensated for the impact of NBN rollout through its commercial arrangements with NBN Co and the Commonwealth. Rather, even after payments under these commercial arrangements are taken into account, Telstra is demonstrably worse off, compared to a 'without NBN' world.

The NBN policy exposed Telstra to a substantial loss of value, whether or not it cooperated with the migration process. In other words, Telstra anticipated that the payments to be received under its commercial arrangements with NBN Co would not be sufficient to compensate for the loss of value caused by the Government's NBN policy. This is explained in the statement of Telstra [redacted], provided to the ACCC in February 2015:[52]

[redacted]

The independent expert review of the proposed commercial arrangements that was presented to shareholders similarly observed that any damage to Telstra from the Government's NBN policy had already been done, and that the commercial arrangements were not designed to compensate for any such damage. The report noted:[53]

> *In considering the Proposal, shareholders need to recognise that it is not a question of whether the Proposal provides "fair compensation" for the impact of the NBN on Telstra. NBN Co has been already established by the government unilaterally and the NBN is being rolled out irrespective of any actions by Telstra. In this respect, the damage has been done and any consequent loss of value has already occurred. The issue for shareholders is simply whether the Proposal now before them is better than the alternatives currently*

[52] Statement of [redacted], February 2015, p 7.
[53] Grant Samuel & Associates, *Financial Services Guide and Independent Expert's Report in relation to the proposed transaction with NBN Co Limited and the Commonwealth*, 31 August 2011, p 31.

available to Telstra. Moreover, the choice is not between the Proposal and returning to the previous status quo in which the NBN did not exist…

On this basis, the independent expert concluded that the proposed commercial arrangements were in shareholders' best interests, in that they provided a better outcome than if Telstra did not co-operate and instead sought to compete with NBN Co.[54]

The ACCC has effectively asserted that Telstra had an opportunity to do better out of its commercial arrangements with NBN Co and the Government, by seeking additional compensation for the effects of the Government's NBN policy, including for the effect of lost economies of scale.

This assertion is contrary to:

- the evidence of [redacted], which explains the various constraints on Telstra's bargaining power in its negotiations with NBN Co and the Commonwealth Government;
- the evidence of [redacted], that Telstra was not fully compensated for the effects of the NBN rollout through its commercial arrangements with NBN Co and the Government; and
- the independent expert report provided to Telstra shareholders, which concluded that the commercial arrangements were in their best interests;

[redacted] states:[55]

[redacted]

1.4.4 The ACCC presupposes that Telstra would have anticipated adjustments that the ACCC said would never be made

As well as presupposing that Telstra had an opportunity to seek compensation for loss of scale economies (an opportunity that Telstra did not have), the ACCC's approach also presupposes that Telstra would have anticipated a need for such compensation. This in turn implies an assumption that Telstra should reasonably have anticipated that it would be deprived of an opportunity to recover any costs that the ACCC may attribute to 'NBN-induced loss of scale economies'. The ACCC appears to be saying that Telstra should have anticipated the adjustments now being made by the ACCC to the building block model, at the time it was negotiating with NBN Co and Commonwealth – and then sought to be compensated for them.

At the time it was negotiating with NBN Co (around 2010 / 2011), Telstra could not have reasonably anticipated that the ACCC would not allow it to recover costs attributable to the loss of scale economies due to NBN rollout. As explained above, such an approach is entirely contrary to the Fixed Principles, the building block model approach, and the ACCC's repeated public statements about the need for an access pricing regime that ensured certainty, including beyond the expiry of the 2011 FAD. The ACCC appears to be suggesting that Telstra could and should have expected that the ACCC would act in a way in which it said it would not act. Telstra could not have anticipated such an approach.

On the contrary, Telstra had a reasonable expectation that under the Fixed Principles methodology (adopted by the ACCC in 2011, around the same time as Telstra concluded its negotiations with NBN Co and the Government) it would have a reasonable opportunity to recover the costs of

[54] Grant Samuel & Associates, *Financial Services Guide and Independent Expert's Report in relation to the proposed transaction with NBN Co Limited and the Commonwealth*, 31 August 2011, p 29.
[55] Statement of [redacted], July 2015, p 3 (Attachment 7).

supplying the declared services for so long as it is obliged to do so. On the basis of this expectation, Telstra would not have considered it necessary to seek compensation from NBN Co for NBN-induced loss of scale economies, even if it was able to do so.

Mr Balchin notes:[56]

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

1.4.5 The exceptional treatment of NBN impacts is arbitrary

The ACCC treats the loss of economies of scale due to NBN migration as a 'special case', requiring exceptional treatment. NBN-induced loss of economies of scale is treated differently to any other factor which might affect unit costs, such as fixed-to-mobile substitution or changes in input costs.

Where unit costs rise (or fall) for any reason unrelated to the NBN, Telstra is allowed to pass on any unit cost increase, and is required to pass on any unit cost reduction. However where there is an increase in unit costs that is deemed to be caused by NBN migration, the ACCC has decided that this cannot affect access prices.

This approach is arbitrary and lacking any reasoned basis. There is no reason why a change in unit costs caused by NBN migration ought not be factored into the calculation of access prices under the Fixed Principles.

This exceptional treatment of NBN-related impacts also undermines the regulatory certainty that the Fixed Principles were designed to provide for.

1.4.6 The Allocation Adjustment is not necessary to avoid "absurd" price levels for some customers

The ACCC has stated that its decision to deny Telstra the recovery of these costs is necessary to avoid prices for certain customers reaching "absurd levels" that would occur in the absence of this adjustment.[57]

This suggestion is not supported by the facts that are before the ACCC and which it has accepted in assessing Telstra's forecasts for expenditure and demand. In the ACCC's own modelling accompanying the Further Draft Decision, it is apparent that the one-off uplift required to provide Telstra an opportunity to recover its costs is only 5.5% in nominal terms.

This equates to a price ***decrease*** in real terms over the forecast period to June 2019.

It is therefore incorrect to assert that this denial of recovery of Telstra's efficiently incurred costs is required to avoid an "absurd" price outcome for end users.

---

[56] Incenta, *Comment on the ACCC further draft decision in relation to fixed line services*, April 2015, pp 13-14 (Attachment 4).
[57] 'ACCC draft Fixed Line Services decision sees one-off uniform fall in access prices of 9.6%', media release, 29 June 2015.

In any event, *even if* at the time of the next FAD forecast levels of costs and demand were expected to potential require a significant further increase to regulated rates, the ACCC has a number of mechanisms within the regulatory framework to address this issue (if it were to arise). For example, the ACCC could seek to shorten asset lives and adjust depreciation profiles to bring forward future capital costs to the current FAD period – allowing these costs to be recovered over a larger end-user base (i.e. before the bulk of migration occurs).

1.5 The ACCC's implementation of the allocation adjustment is flawed

For the reasons set out in sections 1.1 to 1.4 above, the concept of the Allocation Adjustment is not permissible under the Fixed Principles or necessary to account for the risk of "absurd" price levels arising from the application of the BBM approach under the Fixed Principles.

However, even if this were not the case and the Fixed Principles allowed for the Allocation Adjustment, the manner in which the ACCC has implemented the adjustment is logically inconsistent and does not reflect reasonable outcomes that may occur under a credible counterfactual. As explained below, there are several problems with the ACCC's modelling of unit costs in the hypothetical "without-NBN" world, including:

- **Wrong counterfactual**. To assume a world without the NBN is not plausible. The NBN has been a reality for the telecommunications industry since it became Government policy more than five years ago. Using a "without-NBN" counterfactual implies an assumption that any loss of economies of scale due to this Government policy decision should be entirely borne by Telstra. This is an entirely unreasonable assumption, given that Telstra is no more responsible for this Government policy decision than any other user of the fixed-line network.

- **Inconsistent implementation**. The ACCC's modelling of unit costs in the hypothetical "without-NBN" world relies on a number of inconsistent assumptions. In relation to demand, the ACCC uses a hypothetical view of what demand would be like in a "without NBN" world. However on the other hand, the ACCC takes the RAB as it is today (i.e. the real world RAB). Thus, the ACCC does not take into account the fact that, while demand may have been higher had the NBN not been rolled out, Telstra's costs (including capital costs) would also have been higher.

In this section, Telstra provides further information on why the ACCC's implementation of the hypothetical scenario in the ACCC's modelling does not align or provide insight on the issue the ACCC is purporting to address – namely the impact of Telstra entering into the DAs – as well as setting out how the modelled scenario is internally inconsistent.

In addition, this section sets out the result of analysis based on an alternative, internally consistent hypothetical model that estimates the impact on access prices if Telstra had not entered into the DAs. Telstra has developed an alternative view of the "no deal" world – that is, the world without any commercial arrangement between Telstra and NBN Co or the Government – based on the modelling that was undertaken at the time of the DA negotiations. This alternative counterfactual takes into account the reality that no deal between Telstra and NBN Co would not mean no NBN.

The results of this analysis are clear. If Telstra had not entered into the DAs with the Government and NBN Co, then access seekers would be facing *higher* prices today than under current conditions. This is because, in a "no deal" world, demand for fixed line services would still be declining (although not at the same rate), but Telstra would be incurring higher costs than today in order to continue operating the fixed line network.

In short – by cooperating with NBN Co and the Government, Telstra reduced the cost of migration for all of industry and reduced the impact from what it would have otherwise been. Despite this, the effect of the Further Draft Decision would be to allocate to Telstra all of the loss of scale economies for the (more efficient) migration process and its impact on demand for remaining services.

1.5.1 The ACCC's counterfactual does not align with its view of the 'problem'

The ACCC's stated reason for disallowing full recovery of the legitimate costs of supplying the fixed line services is that there has been (or is expected to be) a loss of scale economies of scale as a result of Telstra entering into commercial arrangements with the Government and NBN Co.[58]

Therefore the ACCC has developed a hypothetical cost model in which the NBN is assumed not to have been rolled out and Telstra's costs are (broadly) held at FY2014 levels. This hypothetical cost model is then used to adjust the price outcomes from the ACCC's network model which results in a change to the required nominal price movement from +5.5% to -9.6%.

However there is a disconnect between the concern that the ACCC has identified and its proposed remedy. The issue identified by the ACCC is that there will be a loss of economies of scale caused by Telstra entering into commercial arrangements with the Government and NBN Co. However the ACCC's remedy is to seek to remove the effect of lost economies of scale due to the NBN rollout. What the ACCC's reasoning fails to recognise is that there was going to be a loss of economies of scale associated with the NBN rollout, whether or not Telstra entered into its commercial arrangements with the Government and NBN Co.

The ACCC's approach does not reflect the fact that the NBN was going to occur, irrespective of whether Telstra entered into the Definitive Agreements. The rollout of the NBN was announced, planned and commenced prior to the Definitive Agreements being entered into. The relevant Ministers, NBN Co, Telstra, the ACCC and market analysts, all acknowledged at the time of the DA negotiations that NBN Co did not require an agreement with Telstra to build the NBN. Telstra did not cause the NBN rollout and was not in a position to stop the rollout if it had not entered into its agreements. These facts are set out in Attachment 1 and in the statement of [redacted].

1.5.2 The ACCC's counterfactual is internally inconsistent

As noted above, the ACCC's methodology for calculating the Allocation Adjustment involves hypothesising a world in which the NBN does not exist (but where Telstra's capital and operating costs have already reduced to current levels), and then seeking to adjust for the difference between unit costs in the real world and this "without-NBN" hypothetical world. The objective appears to be to ensure that access prices reflect the unit cost of supplying services in a hypothetical "without-NBN" world, rather than real world unit costs.

Even if this was the correct approach (which it clearly is not) the ACCC's approach to implementing the counterfactual is flawed – it is not a true picture of the world without the NBN or a world where Telstra did not enter into the DAs with the Government and NBN Co. Further, the assumptions used to implement the model are internally inconsistent and don't reasonably reflect an environment in which Telstra did not enter into the DAs, or a world in which the NBN policy was never implemented.

As shown in Table 6 below, the various assumptions used in the ACCC's counterfactual analysis are internally inconsistent.

Table 6: Assumptions required for the ACCC's counterfactual analysis

Assumption required	ACCC assumption
Forecast demand	**No NBN** The ACCC uses a demand forecast that reflects a hypothetical world without the NBN. This is based on actual FY2014 demand and Telstra's "Pre NBN" forecasts. Although imperfect, the demand figures are likely a

[58] Further Draft Decision, p 72.

Assumption required	ACCC assumption
	reasonable estimate of demand if the NBN policy had not been implemented. However, these demand figures are <u>not reasonable</u> if the purpose of the hypothetical model is estimate demand in a scenario in which the NBN policy was implement but Telstra did not enter into the DAs.
Opening RAB	**Real world (i.e. with NBN and where Telstra has entered into the DAs).** In setting prices for FY2016 to FY2019, the ACCC uses the opening RAB as it is in the real world – that is, with the NBN rollout. The NBN policy was implemented in 2007 (and then redesigned in 2009). From this point Telstra's capital expenditure decisions have been impacted by the knowledge that the NBN would be rolled out. The real world RAB reflects the fact that Telstra has reduced capex below what would have otherwise been required had the NBN not been rolled out.
Forecast capex	**Real world base year, adjusted forecasts** In its scenario, the ACCC bases forecast capex on Telstra's real world forecasts and makes certain adjustments to attempt to isolate the impact of NBN from future capex. However, current capex levels (in the real world) are already significantly lower than in earlier years – reflecting the fact of the NBN. Therefore the forward-looking adjustments made by the ACCC are at best a partial adjustment and unlikely to reflect reasonable capex level under the hypothetical scenario.
Forecast opex	**Real world base year, flat forecast** The ACCC assumes that operating expenditure would essentially remain flat in its hypothetical 'without NBN' world. It is not clear what the basis for this assumption is.

The net result of the errors in the ACCC's hypothetical model mean that demand is significantly overstated and costs – particularly capital costs – are understated. The ACCC considers that they have made "conservative" adjustments in order to estimate the hypothetical scenario[59], however:

- The assumptions are clearly inconsistent with any reasonable state of the world. They neither reflect conditions that would exist if Telstra did not enter into the DAs (as demand is too high), nor do they reflect conditions if the NBN policy had not been implemented (as costs are too low).

- To the extent the ACCC has made adjustments to Telstra's costs it has only made adjustments on a forward looking basis and does not adjust the base year levels of operating expenditure or base year levels for capital expenditure (or the opening RAB value which incorporates prior expenditure). This is not reasonable as the counterfactual envisaged by the ACCC envisages a hypothetical world with either no NBN policy or no DAs – both of which would result in Telstra facing capital and operating costs different to current levels.

[59] Further Draft Decision, p 76.

Further, the ACCC has made these adjustments and developed its hypothetical cost model in the absence of relevant information or input from Telstra. Telstra has provided extensive information on the costs it faces under real world conditions now and over the regulatory period to FY2019, however this information does not represent the costs or demand Telstra would face under the hypothetical scenario either in which Telstra did not enter into the DAs or the NBN policy was not implemented. Further, although Telstra's FLSM forecast model does look at the relationship between the NBN rollout, demand and costs this is done on a *forward looking basis* and relies on current real world expenditure as a base year. For the reasons outlined previously, current base year expenditure is not a reasonable assumption under the hypothetical scenario envisaged by the ACCC.

1.5.3 An alternative counterfactual

It is important to reiterate that any hypothetical cost modelling activity (including of the kind undertaken by the ACCC in purporting to estimate the loss of economies from Telstra entering into the Definitive Agreements) involves judgments and the use of assumptions to model an environment that is different from real world conditions and forecasts based on reasonable projections of current conditions. Any hypothetical modelling activity will be inferior to models based on real world conditions as they necessarily involve making assumptions about a world that does not exist.

This concern is a key reason why the ACCC deliberately moved away from the use of hypothetical cost models when it established the BBM-based FLSM and the Fixed Principles for the purposes of setting fixed line services prices.

Although there are limitations to the use of hypothetical cost models, it is possible to develop "better" counterfactuals by ensuring the counterfactual is internally consistent and reasonably reflects the hypothetical scenario.

With this in mind, if the ACCC were minded to continue to engage in speculation about what unit costs would be in a world without the Definitive Agreements, the appropriate counterfactual would be one in which:

- the NBN would have continued to be rolled out;
- Telstra would have had to compete with the new network;
- in competing with the NBN Telstra would have lost a significant number of retail and wholesale fixed line services customers whilst having to maintain its network in order to support its remaining customers and compete with the NBN for new customers; and
- there would have been no orderly, planned migration from one network to the other.

Telstra has developed an alternative view of the "no deal" world – that is, the world without any commercial arrangement between Telstra and NBN Co or the Government – based on the modelling that was undertaken at the time of the Definitive Agreements negotiations. This alternative counterfactual takes into account the reality that no deal would not mean no NBN.

The counterfactual has been developed with inputs from financial modelling undertaken by Telstra at the time of the negotiations with the Government and NBN Co, which took place between 2009 and 2011. This modelling (**NBN Value Analysis**) is described in the statement of [redacted].[60]

Telstra has developed two scenarios. The first is drawn directly from the 2011 analysis and assumes that the NBN rollout would have stayed "on track" and in line with the public statements of

[60] Second Statement of [redacted], July 2015 (Attachment 6).

NBN Co at the time. This scenario then adjusts Telstra's fixed line capex, opex and demand to reflect the "compete" scenario information from the NBN Value Analysis.

A second scenario is also developed in which the same assumptions are applied on a delayed basis. This assumes that the NBN rollout would have been delayed whether or not Telstra entered into the Definitive Agreements (compared to the rollout forecasts published by NBN Co at the time of the negotiations) and that the impact on Telstra of competing with NBN Co (in terms of changes to capex, opex and demand) would be realised on a delayed basis.

The key insights from these counterfactuals are:

- Under a scenario in which Telstra did not enter into the Definitive Agreements, Telstra would still have faced significant competition from the NBN for the provision of fixed line services.
- Compared to the real world (i.e. where Telstra did enter into the Definitive Agreements), Telstra would have faced higher capital costs and higher operating expenditure.
- Although demand for fixed line services would be higher than under the real world conditions, due to competition from the NBN, demand for fixed line services would be lower than under a "no-NBN" scenario.

Overall, the effect on access prices if Telstra were to have not entered into the Definitive Agreements is estimated to be:

- A 17.3% nominal increase from current prices based on Telstra competing with NBN under the projected NBN rollout timetable at the time of the negotiations;
- A 6.4% increase in current prices based on Telstra competing with the NBN under a delayed NBN rollout timetable.

Under each scenario – whether assuming the rollout would have remained on its original timeline or allowing for the subsequent delays in the rollout – the combined effect of the loss of customers to the NBN with the need to continually invest in and operate the network means that Telstra entering the Definitive Agreements would result in greater increases in nominal prices than is estimated by the ACCC's own modelling without the Allocation Adjustment.

This is an intuitive result. As is clear from all available evidence, the NBN was being built with or without the involvement of Telstra. If Telstra had competed with the NBN it would have faced higher costs in order to maintain and operate its network (including the need to continue to invest in its network in order compete) and yet would still face some loss of demand due to the presence of a competitor network.

Further detail of the modelling work undertaken by Telstra to develop the alternative counterfactual analysis is set out in Attachment 2.

1.6 The outcome of applying the NBN adjustments

The outcome of applying the ACCC's adjustments belies the inappropriateness of the modelling approach used to develop the hypothetical. Although the ACCC acknowledges that prudent operating costs are falling more slowly than demand (which implies that unit costs must be rising), its adjustments for NBN impacts result in access prices falling by approximately 10%.

Further, while the ACCC purports to adjust for "loss of economies of scale", it clearly does much more than this through the Disposals Adjustment and Allocation Adjustment. The ACCC's approach to removing the effect of lost economies of scale does not result in no change in prices, as one would expect, but rather results in a 9.6% drop in prices.

The impact of the ACCC's adjustment is starker if accounting for inflation and considering the price change in real terms. In this case the ACCC's proposal would result in a real price decrease of more than 18% by FY2019. In contrast if the ACCC had not applied its allocation adjustment, then based on the ACCC's own modelling within the Further Draft Decision, prices would decline in real terms by 4% by FY2019.

The outcome of the allocation adjustment is contrary to the ACCC's stated objective of providing certainty and stability during the period of transition to the NBN, through consistent application of a well-understood pricing approach. The ACCC has applied an entirely new and unconventional adjustment to its pricing model, in a way that is inconsistent with the Fixed Principles that it established only four years ago. The result of this adjustment is a large and unexpected drop in access prices, at a time when the unit cost of supplying the declared services is rising.

The approach taken in the Further Draft Decision will undermine certainty during the transition to the NBN. By departing significantly from the Fixed Principles framework, the ACCC has undermined the certainty which it sought to provide in establishing those principles in the 2011 FADs.

The Further Draft Decision also results in a very significant reduction in prices, at a time when real price stability is important for the industry. Telstra has previously highlighted the importance of real price stability – that is, the maintenance of price levels and relativities that are broadly consistent with established regulatory rates in real terms, and consistency with established pricing methods – during the transition period.[61] The Further Draft Decision does not provide this, and therefore risks disrupting the industry transition to the NBN.

[61] Telstra, *Public inquiry into final access determinations for fixed line services—primary prices: Response to Discussion Paper*, 3 October 2014, p 26.

2. Other issues raised in the Further Draft Decision

In the Further Draft Decision, the ACCC accepts as prudent and efficient Telstra's operating and capital expenditure (excluding NBN-related expenditure), subject to some additional clarification being provided by Telstra.

The three areas in which the ACCC seeks clarification are:

- allocation of indirect fault reporting costs to fixed-line services;[62]
- property rental costs associated with the supply of fixed line services;[63]
- allocation of propex to the ITS cost centre.[64]

Clarification on each of these issues is provided in Attachment 3. As always, Telstra would be happy to provide further clarification, if required.

[62] Further Draft Decision, p 28.
[63] Further Draft Decision, pp 28-29.
[64] Further Draft Decision, pp 41-42.

Attachment 1: NBN timeline

Date	Event	Details of event	Reference
7 April 2009	Government announces termination of RFP process for "NBN Mark 1" (FTTN) Government announces intention to create a new company to build and operate the NBN using FTTP technology Government releases a discussion paper on the NBN, inviting public comment.[65]	*Summary of Minister's media release*:[66] Based on the Panel's recommendation, the government decided to **adopt FTTP technology** to connect 90 per cent of Australian premises; remainder by mix of next generation wireless and satellite technology. *From National Audit summary of the events*:[67] "The Government's choice of a fibre based technology platform for the NBN and the quantum of government funding available to the successful proponent(s) meant that Telstra's assets, including its customer access network and ducts from the exchange, were a critical dependency for the success of the NBN RFP process. It was generally accepted that the only other technology for a national fibre based network, FTTP, would require a significantly greater government contribution to be commercially viable. Analysis by DBCDE as the RFP progressed determined that, although a FTTN network could co exist with copper based broadband networks, the amount of government assistance on offer meant it was unlikely to be commercially viable for reasons that included its ability to attract enough customers to cover its costs and that it would still require access to Telstra's customer access network."	Senator the Hon. Stephen Conroy, *New National Broadband Network*, media release, 7 April 2009; *Independent Audit*, *NBN Public Policy Processes*, *April 2008 – May 2010*, 7 March 2014, 113; ANAO, *The National Broadband Network Request for Proposal Process, Audit Report No 20 2009-10*, 3 February 2010, 21 [26], 22 [27], 36, 88[3.79], 106; Minister for Broadband, Communications and the Digital Economy, *National Broadband Network: Regulatory Reform for 21st Century Broadband, Discussion Paper*, April 2009.

65 https://www.accc.gov.au/system/files/NBN%20Regulatory%20Reform%20for%20the%2021st%20Century%20Broadband%20-%20low%20res%20web.pdf
66 http://pandora.nla.gov.au/pan/80090/20110727-0008/www.minister.dbcde.gov.au/media/media_releases/2009/022.html
67 http://www.anao.gov.au/~/media/Uploads/Documents/2009%2010_audit_report_20.pdf

Date	Event	Details of event	Reference
		“As a consequence, Telstra was inherently well placed to lodge a competitive (and potentially successful) proposal. Non Telstra proposals were likely to present significant risks, including: • the payment of substantial levels of compensation to Telstra for the compulsory acquisition of the right to use its assets; and • potential regulatory changes that would restrict other entities (mainly Telstra) building a parallel fibre based broadband network (which could be inconsistent with Australia's international trade obligations, and therefore at odds with the Government's broadband policy).”) “In the context of developing the Government’s revised broadband approach, the Minister noted a number of lessons learned from the NBN RFP process, including that: • none of the national FTTN proposals was able to satisfactorily address the significant risk for the Government of a major compensation liability arising from the use of Telstra’s customer access network; • the ACCC advised that billions of dollars of FTTN expenditure would be on equipment not used in a FTTP network (that is, the nodes), which could serve to delay the commercial rollout of FTTP; and • the global financial crisis affected the ability of proponents to secure funding for what was estimated as being an $11-15 billion project to build a FTTN network.”	

Date	Event	Details of event	Reference
7 April 2009	Telstra media announcement	*From Telstra's media release*: "Telstra welcomes opportunity to engage Government on broadband rollout."[68]	Telstra, *Telstra welcomes opportunity to engage Government on broadband rollout*, 7 April 2009.
9 April 2009	NBN Co established		
15 September 2009	Government announces reforms to telecommunications regulatory framework	*From Minister Conroy's media release*: [69] "The reforms address the structure of the telecommunications market and provide Telstra with the flexibility to choose its future path." "It is the Government's clear desire for Telstra to structurally separate, on a voluntary and cooperative basis." "The legislation will allow Telstra to voluntarily submit an enforceable undertaking to the Australian Competition and Consumer Commission to structurally separate. The Minister can provide guidance to the ACCC on the matters it would take into account when considering whether to accept the structural separation undertaking." "If Telstra chooses not to structurally separate, the legislation provides for the Government to impose a strong functional separation framework on Telstra. This Bill proposes implementing a functional separation regime by altering the Telecommunications Act 1997 to require that:	Senator the Hon Stephen Conroy, *Historic reforms to telecommunications regulation* (media release), 15 September 2009.

[68] http://www.telstra.com.au/aboutus/media/media-releases/telstra-welcomes-opportunity-to-engage-government-on-broadband-rollout.xml
[69] http://pandora.nla.gov.au/pan/80090/20091110-0000/www.minister.dbcde.gov.au/media/media_releases/2009/088.html

Date	Event	Details of event	Reference
		• Telstra conduct its network operations and wholesale functions at arm's length from the rest of Telstra; • Telstra provides equivalent price and non-price terms to its retail business and non-Telstra wholesale customers; and • this equivalence of treatment is made transparent to the regulator and competitors via strong internal governance structures." "The legislation will seek to promote competition across telecommunications platforms while allowing Telstra the flexibility to choose its future path." "Telstra will be prevented from acquiring additional spectrum for advanced wireless broadband while it: • remains vertically integrated; and • owns a hybrid fibre coaxial cable network; and • maintains its interest in Foxtel." "The legislation provides scope for the Minister to remove either or both of the second and third requirements in the event that Telstra submits to the ACCC an acceptable undertaking to structurally separate."	
		From The Australian *article*:[70] "Outside the conference, Senator Conroy stressed: 'We will build the NBN with or without Telstra and while it would be cheaper and quicker with	John Durie, 'Senator Stephen Conroy won't delay NBN legislation for Telstra', *The Australian* (online), 14

[70] http://www.theaustralian.com.au/business/latest/senator-stephen-conroy-wont-delay-nbn-legislation-for-telstra/story-e6frg90f-1225786575788

Date	Event	Details of event	Reference
		Telstra's help, we don't need them to build the network, we are building the network irrespective of the outcome of the talks with Telstra.'" "The NBN legislation is aimed at getting Telstra to agree to a deal and flags several moves if it fails to agree, including denial of new mobile phone spectrum and forced separation and divestiture of its 50 per cent of Foxtel."	October 2009.
		From Crikey *(online) article*: [71] "Telstra will in effect be made an offer it can't refuse, invited to develop a plan for full structural separation between now and the end of November via an enforceable undertaking to the Australian Competition and Consumer Commission. If it does not do so, the government will impose a "strong functional separation framework on Telstra" and ban it from acquiring additional wireless spectrum, where it developed a strong presence under Sol Trujillo." "Telstra can break itself up or be broken up. Conroy would prefer the former, but has committed to the latter if necessary." "The government may also prevent Telstra from acquiring more wireless spectrum if it does not divest its hybrid fibre coaxial cable network and its interest in Foxtel. In short, Telstra has been told it will be locked out of the future of communications unless it co-operates with the new regulatory approach."	Bernard Keane, 'Conroy orders Telstra to do the splits', *Crikey* (online), 15 September 2009

[71] http://www.crikey.com.au/2009/09/15/conroy-orders-telstra-to-do-the-splits/

Date	Event	Details of event	Reference
		From ABC News *(online) article*: [72] "If Telstra does not voluntarily separate, then the Government's legislation will force it to offload its cable TV stake if it wants to acquire more spectrum for mobile broadband."	Peter Ryan and Michael Janda, 'Telstra slides as Government forces separation issue' *ABC News* (online), 15 September 2009
		From Telstra's media release:[73] "Telstra remains committed to working with Federal Government." "It is Telstra's view that many aspects of this package are unnecessary and need never be implemented if a mutually acceptable outcome can be reached on the National Broadband Network. "Telstra supports the Government's NBN vision. We are willing to discuss options around separation."	Telstra, *Telstra remains committed to working with Federal Government* (media release), 15 September 2009;
		From Senator Minchin's 15 September media release: "The Government's decision to force the structural separation of Telstra makes no sense given its determination to spend $43 billion to build a National Broadband Network Shadow Minister for Broadband, Communications and the Digital Economy Senator Nick Minchin said today."	Senator The Hon Nick Minchin, *Why Break-Up Telstra If Government is Determined to Build its NBN?* (media release), 15 September 2009.
		From Senator Minchin's 30 September media release: "The Rudd Government should remove the gun from Telstra's head and enter into proper commercial negotiations with the company about its desire to use	Senator The Hon Nick Minchin, *Telstra Should Not Buckle Under Labor's Threats* (media release), 30

[72] http://www.abc.net.au/news/2009-09-15/telstra-slides-as-government-forces-separation/1429778
[73] http://www.telstra.com.au/aboutus/media/media-releases/telstra-remains-committed-to-working-with-federal-government.xml

Date	Event	Details of event	Reference
		Telstra's facilities in order to ensure the viability of its $43 billion National Broadband Network proposal Shadow Minister for Broadband, Communications and the Digital Economy Senator Nick Minchin said." "The Rudd Government's charade that it could build the NBN without Telstra has been exposed by its desperate threats and ultimatums to the company in a bid to pinch its customers, gain access to the assets it needs for any roll out and at the same time reduce its capacity to compete against a new Government-owned monopoly." "The reality is, despite all Labor's talk about building a new national network, both the Government's failed NBN Mark I proposal and this latest $43 billion pledge were based on the fibre upgrade of Telstra's existing network." "The Government is trying to force Telstra to help it deliver on an overblown promise regardless of the cost and its radical behaviour suggests Labor needs Telstra more than the company needs it."	September 2009.
		From Senator Minchin's 4 November opinion piece in The Australian: "If Telstra does not cave in to Labor's demands it will face mandated functional separation and be barred from acquiring the spectrum it needs to upgrade its mobile network to higher speeds and capacity."	Senator the Hon Nick Minchin, 'Without Telstra, NBN Likely to be a Huge White Elephant - Opinion Piece', *The Australian* (online), 4 November 2009.
		From Senator Minchin's 4 November media release: "The shareholders urged the board to stand up for their interests and not be bullied into an agreement which could permanently damage the company's value."	Shadow Minister for Broadband, Communications and the Digital Economy, *Telstra Shareholder Anger Justified* (media release), 4 November 2009.

Date	Event	Details of event	Reference
13 October 2009	Senate inquiry into the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009	*Statements from Mr Booth (Telstra Representative)*:[74] "If the Senate decides to proceed with the bill it should, at the very least, defer the debate. If the Senate decides to proceed with the bill we urge that significant amendments are made to the bill. Our submission details a number of concerns with the current provisions of the bill. These include the functional or structural separation of Telstra; the proposed exclusion of Telstra from acquiring more wireless spectrum unless it agrees to vertical and horizontal structural separation; the requirement that Telstra sells its HFC—hybrid fibre coax—and Foxtel assets in order to avoid being excluded from spectrum for future generations of mobile services; and some of the proposed changes to the Trade Practices Act, including changes to the access regime, which will give the regulator significant powers without setting out very careful prescriptions on how these powers should be used, and also changes to the anti-competitive conduct regime which exempts the ACCC from procedural fairness obligations." "For example, the minister's power to waive the requirements for Telstra to divest either both of the HFC or Telstra's interest in Foxtel does not flow automatically from the acceptance of a structural separation undertaking by the ACCC. This means that Telstra has no certainty that it will in fact receive the benefits of those waivers if it commits itself to a structural separation undertaking, an undertaking from which, under the bill, we cannot withdraw. It is not clear at this stage that Telstra could lodge a conditional structural separation undertaking. In short, this part of the bill would make it extremely difficult for the Telstra board to come to a judgment that any agreement on the NBN was in the best interests of its shareholders, as it provides little	Parliament of Australia, *Environment, Communications and the Arts Legislation Committee, Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009*, 13 October 2009.

74 http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;orderBy=_fragment_number;query=((Dataset%3Acommsen)%20SearchCategory_Phrase%3A%22committees%22)%20CommitteeName_Phrase%3A%22environment,%20communications%20and%20the%20arts%20legislation%20committee%22%20Responder_Phrase%3A%22mr%20booth%22;rec=0

Date	Event	Details of event	Reference
		certainty regarding the legislative context in which Telstra would operate after the conclusion of such a deal."	
3 December 2009	ACCC initiates review of access pricing principles for fixed line services	ACCC seeks industry comment on the development of a new approach to access pricing for the declared fixed line services and canvasses various options with industry, such as the adoption of a 'building block' pricing approach.	ACCC, *Review of 1997 Guide to Telecommunications Access Pricing Principles for Fixed Line Services: Discussion Paper,* December 2009
18 December 2009	Telstra and NBN Co agree on Terms of Engagement for negotiations regarding Telstra's participation in the roll out of the NBN		Senator the Hon Stephen Conroy, *Terms of Engagement agreed between Telstra and NBN Co*, 18 December 2009.[75]
20 June 2010	Telstra signs Financial Heads of Agreement on NBN		Telstra, *Telstra signs Financial Heads of Agreement on NBN*, 20 June 2010.[76]
17 September 2010	ACCC publishes draft report on review of access pricing principles for fixed line services	ACCC proposes to shift from TSLRIC+ based pricing principles to building block model (BBM) pricing principles for the declared fixed line services. The ACCC explained its reasons for the proposed shift as follows: "The ACCC considers that moving to a BBM pricing approach meets the objective of promoting the LTIE. This conclusion is supported by the arguments against the continued application of TSLRIC+ pricing set out above.	ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services: Draft report*, September 2010

[75] http://pandora.nla.gov.au/pan/80090/20110727-0008/www.minister.dbcde.gov.au/media/media_releases/2009/117.html
[76] http://www.telstra.com.au/aboutus/media/media-releases/telstra-signs-financial-heads-of-agreement-on-nbn-1.xml

Date	Event	Details of event	Reference
		By locking-in a value for the RAB, the BBM will improve certainty for both the access provider and access seekers. This will enable them to make efficient decisions regarding their future investment patterns and general business plans, thereby promoting economically efficient investment in infrastructure. Locking-in a value for the RAB will promote predictable revenue and price paths and minimise the prospect of windfall gains or losses. It will reduce the risk that efficient expenditure will not be recovered, which will in turn promote efficient investment in infrastructure and promote competitive entry and competition in the relevant markets. The ACCC considers that the BBM pricing approach meets the objective of ensuring that the access provider is adequately compensated for its costs over time. As noted above, the BBM calculates the revenue required to cover the access provider's efficient costs, including a commercial return on investments. This is also consistent with the general regulatory principle that a regulated business should expect to receive sufficient revenue to allow it to cover all expected prudent expenditure necessary to maintain a given level of service at each period into the future. This means that the access provider's legitimate commercial interests are met and investment in regulated infrastructure over the long term is not discouraged. This promotes dynamic efficiency and the ongoing provision of services to consumers and efficient investment in infrastructure by the access provider."	
1 January 2011	Changes to Part XIC (including introduction of access determination powers) take effect.		

Date	Event	Details of event	Reference
21 April 2011	ACCC publishes discussion paper in relation to making final access determinations for the declared fixed line services	ACCC confirms its intention to adopt a BBM pricing methodology to estimate prices for the six declared fixed line services, noting that there has been broad industry support for moving to a BBM approach. ACCC proposes use of fixed principles provisions to lock in certain aspects of the BBM approach, noting that this will provide certainty about how the ACCC will estimate prices for the declared fixed line services across regulatory periods. The ACCC observed that certainty over time on the pricing framework will assist industry participants in their business and investment planning during the transition to the NBN. The ACCC explained the rationale for its proposed fixed principles as follows: "The fixed principles provisions proposed in this discussion paper would provide certainty over time for industry participants on the pricing framework used by the ACCC to implement a BBM approach to estimating prices for the declared fixed line services. A major rational for moving to a BBM approach was to improve pricing certainty for all industry participants. The ACCC recognises that it has not previously consulted explicitly on making fixed principles provisions. Such provisions were not available under the previous legislation. However, the ACCC has consulted extensively since December 2009 on the appropriate pricing framework for the declared fixed line services and on the details of how the BBM approach should be implemented. The ACCC is of the view that including fixed principles provisions in the FADs will provide certainty about how the ACCC will estimate prices for the declared fixed line services after the end of the proposed five-year regulatory period in 2016. Certainty over time on the pricing framework will assist industry participants in their business and investment planning during the	ACCC, *Public inquiry to make final access determinations for the declared fixed line services: Discussion paper*, April 2011

Date	Event	Details of event	Reference
		transition to the NBN. The ACCC considers that the provisions proposed in this discussion paper will promote regulatory certainty by ensuring that the BBM approach will be implemented consistently and predictably in future regulatory periods. Further, the ACCC considers that the proposed fixed principles provisions are likely to reduce the regulatory burden and the time required to conduct price resets by removing the need to review all aspects of the pricing framework at every price reset. Setting fixed principles provisions can also promote price stability. An example of this is locking in the initial RAB used in the FLSM for estimating prices for the declared fixed line services. As noted in chapter 4, the continual revaluation of network assets under the previous TSLRIC+ approach created ongoing uncertainty over the level of access prices."	
23 June 2011	Telstra signs NBN Definitive Agreements	*From Telstra's media release*:[77] "The Government's commitment to the NBN and other related policy changes meant that the Telstra Board had to decide whether the company should participate in the NBN rollout or pursue other options. The decision to participate was made on the basis that the proposed transaction is expected to provide us with the ability to recover more value for the business than the available alternatives, given the loss of value after the NBN policy announcements." "After rigorously assessing the options before it, including the regulatory and commercial implications of each, the Telstra Board expects to recommend that shareholders approve a proposal to participate in the NBN rollout, subject	Telstra, *Telstra signs NBN Definitive Agreements*, 23 June 2011.

[77] http://www.telstra.com.au/aboutus/media/media-releases/telstra-signs-nbn-definitive-agreements-2.xml

Date	Event	Details of event	Reference
		to the conditions precedent being satisfied." "The agreements provide Telstra with replacement revenue, through disconnection payments as the rollout of the NBN occurs, and new revenues, through access payments for the use of Telstra's infrastructure over an assumed average 30 year period. Consistent with the Financial Heads of Agreement signed in June 2010, the arrangements under the Definitive Agreements and associated Government policy commitments are expected to deliver approximately $11 billion in post-tax net present value over their long-term life. This value will not be in the form of an upfront payment, but is the present value of payments to be received over many years. This value is also subject to a range of dependencies and assumptions over the life of the agreements." "Telstra expects that the consideration for the disconnection of its relevant copper and HFC cable broadband services, as well as appropriate commercial terms for scale access to its infrastructure, together with benefits from associated Government policy commitments, will produce a net result that is superior to other options realistically available to the company. "	
20 July 2011	ACCC releases its final access determinations for the declared fixed line services.	ACCC again affirms its decision to adopt a BBM approach and includes fixed principles provisions locking in this approach. The fixed principles provisions are to apply for a ten year period with a nominal termination date on 30 June 2021. ACCC states that "this will give the industry pricing certainty during the transition to the NBN."	ACCC, Inquiry to make final access determinations for the declared fixed line services: Final Report, July 2011
1 August 2011	Telstra lodges Structural Separation Undertaking and Migration Plan with		Telstra, *Telstra lodges Structural Separation Undertaking and Migration Plan with ACCC*, 1 August

Date	Event	Details of event	Reference
	ACCC		2011.[78]
18 October 2011	Telstra shareholders approve deal between Telstra and NBN Co	Deal recommended to shareholders on the basis that the it is likely to offset part of the loss of value associated with the Government's commitment to introduce the NBN and separate parts of Telstra's business, and that it will deliver an overall result that is materially superior to any other option realistically available to Telstra, given current Government policy. The independent expert report provided to shareholders emphasised that in deciding whether to accept the proposed deal, the question was not whether the deal provided fair compensation for all of the effects of the NBN rollout. Rather, the question was whether Telstra would be better off if it accepted the deal and co-operated in the NBN rollout, compared to a world in which the NBN is still rolled out but Telstra did not cooperate. The independent expert report stated: "In considering the Proposal, shareholders need to recognise that it is not a question of whether the Proposal provides "fair compensation" for the impact of the NBN on Telstra. NBN Co has been already established by the government unilaterally and the NBN is being rolled out irrespective of any actions by Telstra. In this respect, the damage has been done and any consequent loss of value has already occurred. The issue for shareholders is simply whether the Proposal now before them is better than the alternatives currently available to Telstra. Moreover, the choice is not between the Proposal and returning to the previous status quo in which the NBN did not exist as the telecommunications landscape has already fundamentally changed…"	Telstra, *Explanatory Memorandum for the resolution under item 2 at the Annual General Meeting on 18 October 2011: Telstra's participation in the rollout of the National Broadband Network*.

[78] http://www.telstra.com.au/aboutus/media/media-releases/Telstra-lodges-Structural-Separation-Undertaking-with-ACCC

Date	Event	Details of event	Reference
9 December 2011	Telstra lodges revised Structural Separation Undertaking with ACCC.		Telstra, *Telstra lodges revised Structural Separation Undertaking*, 9 December 2011.
23 February 2012	Telstra lodges further revised Structural Separation Undertaking with ACCC.		Telstra, *Telstra lodges revised Structural Separation Undertaking with ACCC*, 23 February 2012.[79]
28 February 2012	ACCC accepts Telstra's Structural Separation Undertaking	.	Telstra, *ACCC accepts Telstra's Structural Separation Undertaking*, 28 February 2012.
7 March 2012	Telstra finalises NBN agreements	*From Telstra's media release*:[80] "CEO David Thodey said the agreements and associated Government policy commitments were expected to provide Telstra approximately $11 billion in post-tax net present value over the long term life of the agreements." "'As was detailed in the Explanatory Memorandum, compared with other realistically available options this outcome should deliver a better overall financial outcome, a more stable regulatory environment and greater strategic flexibility, enabling Telstra to maintain a strong focus on our key areas of	Telstra, *Telstra finalises $11 billion NBN agreements*, 7 March 2012.[81]

[79] http://www.telstra.com.au/aboutus/media/media-releases/telstra-lodges-revised-structural-separation-undertaking-with-accc.xml
[80] http://www.telstra.com.au/aboutus/media/media-releases/telstra-finalises-11-billion-nbn-agreements-1.xml
[81] http://www.telstra.com.au/aboutus/media/media-releases/telstra-finalises-11-billion-nbn-agreements-1.xml

Date	Event	Details of event	Reference
		growth,' Mr Thodey said."	
April 2013	Coalition releases its NBN policy document	*From the Coalition policy document*:[82] "The Coalition reserves the right to review and seek to vary any of those contracts in light of the Coalition's broadband policy and in order to protect the interests of taxpayers. However, the Minister will seek to do so on the basis that in net terms across all variations and any associated transactions or arrangements between the parties, Telstra shareholders are kept whole." "We may seek to negotiation variations to commitments to provide efficiencies, allow the NBN to be more quickly deployed or otherwise create benefit. NBN Co will seek permanent access to Telstra's copper between premises and concentration points such as pillars, cabinets or exchanges. Telstra has publicly stated the copper has minimal economic value, leading us to anticipate cost-effective access will be attainable."	Liberal Party, *The Coalition's Plan for Fast Broadband and an Affordable NBN*, April 2013, 12.
10 April 2013	Mr Turnbull, Shadow Communications Minister, is interviewed on ABC Radio 774 with Jon Faine	*From transcript of radio interview*: [83] "So it is in their interests, because they would get their payment – it wouldn't get any more than they're contracted for but they would get them sooner – it is in Telstra's interests to go along with the proposal we've made which is why all of the stockbroking firms have said, and I think it's a fair comment, that our approach is a mild, not a big positive, but it is certainly a mild positive for Telstra. So Telstra shareholders are no worse off and they might be a little bit better off and that is why Telstra has an interest in going along with that."	Comments by Malcolm Turnbull, 'Transcript of The Hon. Malcolm Turnbull MP', ABC Radio 774 Melbourne, 10 April 2013.

[82] http://lpaweb-static.s3.amazonaws.com/Policies/NBN.pdf
[83] http://www.malcolmturnbull.com.au/communications-broadband/transcript-abc-melbourne-10-april-2013

Date	Event	Details of event	Reference
26 August 2013	Mr Turnbull comments on Coalition's prospective NBN deal with Telstra if elected on Sky News	*Mr Turnbull's comments during interview with Sky News*:[84] "[Telstra's] copper network in the context of an NBN world is of no economic value. It can't be used anymore. So, I'm very confident that we can acquire access, ownership if you like, of the last mile copper for no additional payment." *From* The Age *(online) article*:[85] "Mr Turnbull had previously said Telstra wouldn't receive a cent more from the government in a new deal." "'I'm very confident that we can acquire access, ownership if you like, of the last mile copper for no additional payment,' he told Sky News in August last year [2013]."	Interview with Malcolm Turnbull, Sky News, 26 August 2013. Ben Grubb, 'Malcolm Turnbull expects new Telstra NBN deal in a 'few months', *The Age* (online), 21 February 2014.
7 September 2013	Abbott Coalition Government elected		
12 December 2013	NBN Co releases Strategic Review report[86]	NBN Co recommends that it develops an optimised multi-technology approach to rolling out the NBN that balances fast deployment of 50Mbps broadband with better economics, to the highest number of Australians. NBN Co states that it will decide on its exact priorities after consultation with industry, Government and other stakeholders.	NBN Co, *Strategic Review*, December 2013.

84 https://www.youtube.com/watch?v=0LCFI5m0X3o
85 http://www.theage.com.au/it-pro/government-it/malcolm-turnbull-expects-new-telstra-nbn-deal-in-a-few-months-20140220-hvdaw.html
86 http://www.nbnco.com.au/content/dam/nbnco/documents/NBN-Co-Strategic-Review-Report.pdf

Date	Event	Details of event	Reference
		A high-level assessment of a multi-technology approach suggests that the eventual optimal mix of technologies in the fixed line footprint could be in the range of: FTTP to ~20-26 percent of premises; FTTN/dp/B to ~44-50 percent; and HFC to ~30 percent. Fixed Wireless and Satellite will be used outside the fixed line footprint, along with some FTTN/dp.	
20 February 2014	Minister Turnbull announces that NBN Co and Telstra have commenced renegotiation	*From* The Age *(online) article*:[87] “The renegotiation of the $11 billion deal the Labor government secured with Telstra as part of the national broadband network (NBN) should be completed by the middle of the year, Communications Minister Malcolm Turnbull says.” “The deal was to give the company building the infrastructure project, NBN Co, access to Telstra's ducts, pits, conduits and exchanges to rollout a fibre-to-the-premises network. Telstra's copper was to be decommissioned, and its copper and hybrid fibre coaxial cable (HFC, or Pay TV) customers migrated onto the new network.” “Speaking with Fairfax Media following the launch of the MyBroadband website on Thursday, Mr Turnbull said NBN Co and Telstra had begun renegotiations and planned to complete them ‘in the next few months’.” “‘We're moving ahead but the aim is to ... get this done in the next few months,’ Mr Turnbull said. ‘Certainly by the middle of the year.’” “Mr Turnbull added that both parties were moving ‘quickly’ and that there was ‘a lot of agreement’.”	Ben Grubb, ‘Malcolm Turnbull expects new Telstra NBN deal in a ‘few months’, *The Age* (online), 21 February 2014.

[87] http://www.theage.com.au/it-pro/government-it/malcolm-turnbull-expects-new-telstra-nbn-deal-in-a-few-months-20140220-hvdaw.html

Date	Event	Details of event	Reference
8 April 2014	Government releases statement of Government expectations	*From the Ministers' media release*: "The Government has considered the NBN Co Strategic Review's report of 12 December 2013 and agrees that the NBN rollout should transition from a primarily fibre to the premises (FTTP) model to the 'optimised multi-technology mix' model."	The Hon Malcolm Turnbull, Senator The Hon Mathias Cormann, *Government expectations*, 8 April 2014.
14 December 2014	Telstra signs revised NBN Definitive Agreements.	*From Telstra's media release*:[88] Chief Executive Officer David Thodey said: "We have achieved the key principle, agreed to by the parties, of maintaining the overall value of the original agreements. "As a result, our shareholders have been kept whole in terms of the transaction they approved in October 2011."	Telstra, *Telstra signs revised NBN Definitive Agreements* (media release), 14 December 2014.
11 March 2015	ACCC publishes draft decision on primary price terms for the declared fixed line services		ACCC, ACCC releases draft prices access seekers will pay to use Telstra's copper network, 11 March 2015.
23 March 2015	Telstra lodges revised NBN Migration Plan	.	Telstra, Telstra lodges revised NBN Migration Plan, 23 March 2015.[89]

[88] http://www.telstra.com.au/aboutus/media/media-releases/telstra-signs-revised-nbn-definitive-agreements-1.xml
[89] http://www.telstra.com.au/aboutus/media/media-releases/telstra-lodges-revised-nbn-migration-plan.xml

Date	Event	Details of event	Reference
26 June 2015	Telstra's revised NBN Definitive Agreements come into effect		Telstra, Telstra's revised NBN Definitive Agreements come into effect, 26 June 2015.[90]
26 June 2015	ACCC approves revised migration plan		ACCC, ACCC approves revised migration plan, 26 June 2015.[91]
29 June 2015	ACCC further draft decision on primary price terms for the declared fixed line services		ACCC, ACCC draft fixed line services sees one-off uniform fall in access prices of 9.6%.

[90] http://www.telstra.com.au/aboutus/media/media-releases/telstras-revised-nbn-definitive-agreements-come-into-effect.xml
[91] https://www.accc.gov.au/media-release/accc-approves-telstras-revised-migration-plan-0

Attachment 2: The counterfactual

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]

[redacted]

		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]
[redacted]		[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]

		[redacted]	
[redacted]		[redacted]	
[redacted]		[redacted]	
[redacted]			[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	
	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]	
	[redacted]	[redacted]	
	[redacted]	[redacted]	
	[redacted]		

[redacted] [redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted]

[redacted]

[redacted] [redacted]

[redacted]

[redacted]

[redacted] [redacted]

[redacted] [redacted]

[redacted]

		[redacted]		
[redacted]		[redacted]		
[redacted]			[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]			
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]		[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]			
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]			
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
	[redacted]	[redacted]	[redacted]	
	[redacted]	[redacted]		

[redacted] [redacted]

[redacted]

		[redacted]	
[redacted]		[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
	[redacted]	[redacted]	[redacted]

[redacted] [redacted]

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]

Attachment 3: Response to ACCC queries re expenditure forecasts

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

> [redacted]

[redacted]

> [redacted]

> [redacted]

[redacted]

> [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted] [redacted]
- [redacted] [redacted]
- [redacted] [redacted]

[redacted]

[redacted]

	[redacted]
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

	[redacted]
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

		[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
	[redacted]	[redacted]	[redacted]
	[redacted]	[redacted]	[redacted]

		[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]		[redacted]	[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]

[redacted]

[redacted] [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

	[redacted]	[redacted]
[redacted]		
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]		[redacted]
[redacted]		
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]		[redacted]

[redacted]

[redacted]

> [redacted] *[105]* [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]

- [redacted]

- [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]

	[redacted]
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	

	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

Attachment 4: Expert report of Jeff Balchin

Provided as a separate document.

Attachment 5: Expert report of Keith Lockey

Provided as a separate document.

Attachment 6: Statement of [redacted]

Provided as a separate document.

Attachment 7: Statement of [redacted]

Provided as a separate document.