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# TELSTRA CORPORATION LIMITED

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

Response to industry submissions on the ACCC further draft decision

20 August 2015

**Public version**

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## Executive Summary

Telstra provided its response to the ACCC's Further Draft Decision on primary price terms for the declared fixed line services on 17 July 2015. Since that time, a number of other submissions have been made, including from Optus and iiNet.

This submission is a response to some specific points, including in relation to the impact of the National Broadband Network (NBN), made in submissions by Telstra Wholesale access seekers to the ACCC, which require clarification or correction.

The key points which Telstra seeks to clarify in this submission are summarised below and addressed in greater detail in the body of this submission. Correction of some specific points raised in the Optus and iiNet submissions are summarised in the Attachment.

**Treatment of NBN impacts in the Further Draft Decision**

The Optus and iiNet submissions make a number of claims in relation to the ACCC's adjustments to account for NBN impacts which are incorrect.

In particular:

- **Consistency with the October 2014 Position Statement**. Optus's claim that the ACCC's adjustments are merely an implementation of the October 2014 Position Statement is wrong. While the ACCC foreshadowed a proposal to treat decommissioned assets (as well as those sold to NBN Co) as asset disposals, it did not foreshadow any adjustment to allocation factors to account for the effect of "loss of economies of scale" associated with the NBN rollout. This change in position is responsible for a 15 percentage point reduction in the final price outcome.

- **Cause of the costs that are excluded by the ACCC's adjustment to allocation factors**. It is wrong to suggest that the costs excluded by the adjustment to allocation factors are not caused by users of the fixed-line network. The [Commercial-in-confidence commences] [Commercial-in-confidence ends] costs that the ACCC has excluded are costs that need to be incurred to maintain supply of the fixed line services. Only if Telstra did not have to supply fixed line services could it theoretically avoid incurring these costs.

- **Consistency with the Fixed Principles**. iiNet's submission that the ACCC's adjustments to account for NBN impacts is consistent with the Fixed Principles is incorrect, as set out by Telstra in its July submission.

- **Impact on cost recovery**. iiNet does not seek to argue that Telstra will have an opportunity to recover the cost of supplying the declared services, through declared service charges. Rather, it is argued that Telstra is compensated elsewhere for the shortfall in recovery from the fixed-line services. However the evidence before the ACCC, including the Australian Government, demonstrates that this claim is wrong.

- **Ability to recover shortfall through commercial arrangements with NBN Co**. Telstra has, in its various responses over the last six months, provided evidence from senior managers and public material to demonstrate that the commercial arrangements with NBN Co do not compensate it for these costs. iiNet's assertion that Telstra is compensated through its commercial arrangements with NBN Co is wrong.

- **Perceived generosity to Telstra**. There is no sense in which the ACCC's adjustment to cost allocation factors is 'generous' to Telstra. It cannot be said that by assuming flat operating expenditure in the hypothetical 'without NBN' world (an assumption that is without any basis), the ACCC has applied its adjustments in a way that is generous to Telstra. To the contrary, the assumptions and approach adopted by the ACCC, on its own calculation, result in Telstra losing the opportunity to recover [Commercial-in-confidence commences] [Commercial-in-confidence ends] prudent and efficient costs.

- **Impact on price outcome**. It is claimed by Optus that the ACCC's adjustment for NBN impacts is not driving the downward revision to the draft FAD rates, and that it is actually the rate of return that is driving the outcome. This is not true. Between the March Draft Decision and the Further Draft Decision there was in fact a moderate increase in the rate of return, and yet the price determined by the ACCC dropped considerably. It is clear from the ACCC's Further Draft Decision and the modelling that sits behind this that the primary driver of the large reduction in prices is the ACCC's adoption of a new approach to accounting for 'NBN-induced loss of economies of scale' through adjustments to cost allocators.

**Characterisation of the ACCC's decision in relation to expenditure forecasts and cost allocators**

The Optus and iiNet submissions refer to Telstra's expenditure forecasts as being "inflated" and "excessive". It is suggested by Optus that the ACCC has taken a 'pragmatic' approach, in the sense that it has limited the impact of the 'excessive forecasts' on prices through its adjustment to allocation factors.

This is a mischaracterisation of the Further Draft Decision and the careful review process that has been undertaken in relation to the prudency and efficiency of Telstra's forecasts. The ACCC has not accepted "excessive" forecasts on the basis that this generosity will be offset by its decision to exclude efficient costs elsewhere. It would be improper for it to do so.

The ACCC has reviewed the detailed submissions, hundreds of pages of explanatory material and expert evidence from Telstra in relation to its expenditure forecasts, has undertaken its own review and engaged experts to assist with this review, and has formed a judgement as to the prudency and efficiency of Telstra's forecasts, as required by the Fixed Principles. In large part, the ACCC has accepted that Telstra's forecasts reflect prudent and efficient costs.

Similarly, in relation to individual cost allocators, the ACCC's conclusions are not generous or favourable to Telstra. The ACCC has formed its views on the appropriateness of these individual allocators having regard to the detailed explanatory material and expert evidence from Telstra, stakeholder submissions, and an independent review by its consultant, Analysys Mason.

**Rate of return**

Optus claims that the ACCC has set the rate of return too high.

The evidence in fact indicates that the ACCC has under-estimated a number of key rate of return parameters. In particular:

- Contrary to Optus' claim that the ACCC's equity beta is too high, the current empirical evidence, when properly interpreted (i.e. with appropriate de-levering and re-levering of estimates), shows that Telstra's equity beta is in fact above 0.7;

- The ACCC's decision to maintain a market risk premium (**MRP**) of 6% is inconsistent with current empirical evidence, and is out of step with other Australian regulators;

- Telstra has previously provided evidence that the ACCC's estimate of the debt risk premium (**DRP**) and does not reflect the efficient cost of borrowing faced by Telstra.

**Ability to backdate replacement FADs**

Contrary to claims made by iiNet and Macquarie, the new FADs cannot be backdated. Since they are to replace existing FADs, the commencement date for the new FADs must be the first day after the existing FADs expire.

# 1. NBN impacts and loss of economies of scale

## 1.1 The Allocation Adjustment as an implementation of the Position Statement

Optus characterises the ACCC adjustment to cost allocation factors as an implementation of the October 2014 NBN Position Statement. Optus states that "the implementation of this position should not surprise any interested party, and indeed, failure to implement the position may give rise to procedural fairness issues".[1]

This not the case:

- The ACCC did foreshadow its proposal to treat decommissioned assets (as well as those sold to NBN Co) as asset disposals in the October 2014 Position Paper. However, the ACCC did not foreshadow any adjustment to allocation factors to account for the effect of 'loss of economies of scale' associated with the NBN rollout.

- The October 2014 Position Paper dealt specifically with the treatment of three groups of *assets* that are potentially affected by NBN migration: (a) assets that will be sold to NBN Co; (b) assets that will be leased to NBN Co; and (c) assets that will be decommissioned or utilised to a lesser extent as a result of the NBN rollout.

- The first indication that the ACCC may seek to adjust for the effects of lost economies of scale came in the March draft decision. However in that decision the ACCC stated that it was still considering the issue, and there was no indication of what (if any) adjustment it intended to make.[2] Certainly, the adjustment to allocation factors was not foreshadowed at this time.

- The Further Draft Decision takes a different approach to that taken in the Position Paper. The key point of difference between the Position Paper and the Further Draft Decision is that the Position Paper focuses on *assets* that are affected by NBN migration, whereas the Further Draft Decision seeks to adjust the *total costs* that may be recovered. In the Further Draft Decision, the ACCC proposes to adjust total costs by adjusting the cost allocation factors that apply to all costs, not just assets, to remove the effect of changes in unit costs due to lost economies of scale.[3] Further, as a result of this adjustment, the ACCC has also moved away from its March draft decision to adopt a fully allocated cost framework.[4]

The difference in approach between the Position Paper and the Further Draft Decision is significant. By seeking to exclude the effect of changes in unit costs due to lost economies of scale associated with the NBN rollout, the ACCC ends up disallowing recovery of a significant amount of operating expenditure, tax expenses and capital costs. These are expenses the ACCC has itself accepted are necessary for the prudent and efficient operation of the fixed-line network and which are directly associated with the supply of declared services to wholesale customers over the next regulatory period. This is in contrast to what had been flagged in the Position Paper – that the ACCC would make certain adjustments to the RAB, but still allow Telstra a reasonable opportunity to recover its prudent and efficient operating expenditure, tax expenses and a return on and of the remaining value of the RAB.

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[1] Optus submission, [3.2].

[2] ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, p 141.

[3] The ACCC characterises these lost economies of scale in its draft decision as a form of "cost". For the reasons set out in our July submission, this mischaracterises what has occurred and conflates a 'unit cost' (which is a measure of how costs are shared) with 'costs' actually incurred.

[4] As explained in Telstra's response to the Further Draft Decision, while the ACCC says it maintains its preference for a fully allocated cost approach, it does not adopt a fully allocated cost framework in the Further Draft Decision (Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to ACCC further draft decision, 17 July 2015, pp 19-21).

Given this, it is incorrect and inappropriate for Optus to suggest that there may be "procedural fairness issues" if the ACCC were to remove the adjustment to allocation factors for "lost economies of scale" in its final decision. There would be no procedural unfairness in the ACCC reverting to a fully allocated cost approach, the approach that it indicated it would adopt in the March draft decision

## 1.2 Cause of the costs that are excluded by the ACCC

iiNet claims that the costs that are excluded by the ACCC's adjustment to allocation factors are costs of excess capacity caused by the NBN (and/or Telstra's agreements with NBN Co), and that these costs are not related to the supply of fixed-line services. iiNet states:[5]

> *…the costs of excess capacity caused by the NBN should not be allocated to the services that continue to be supplied over the Telstra's network because the cause of that excess capacity is not related to supplying those services but is instead related to Telstra's agreements with NBN Co.*

It is wrong to suggest that the costs excluded by the adjustment to allocation factors are not caused by users of the fixed-line network.

The [Commercial-in-confidence commences] [Commercial-in-confidence ends] costs that the ACCC has excluded are costs that need to be incurred to maintain supply of the fixed line services. As noted in Telstra's July submission, this includes:

- Approximately [Commercial-in-confidence commences] [Commercial-in-confidence ends] prudent and efficient operating expenditure, which the ACCC has found to be necessary for the efficient operation of the fixed-line network;
- Approximately [Commercial-in-confidence commences] [Commercial-in-confidence ends] tax costs; and
- Approximately [Commercial-in-confidence commences] [Commercial-in-confidence ends] capital costs (including the return on and return of capital) associated with the fixed line assets.

These costs are not caused by NBN migration, or by Telstra's commercial arrangements with NBN Co and the Commonwealth. These costs would not disappear in a 'without NBN' world.

Rather, these costs are caused by the supply of fixed-line services. Were it not for Telstra's obligation to supply fixed-line services, it would not incur these costs.

The iiNet submission appears to confuse the question of cost causation with the causation of changes in <u>demand</u> and the consequential effects on <u>unit</u> costs. Telstra accepts that the allocation of <u>costs</u> should reflect causal relationships between supplying services and incurring costs. However it is not appropriate, and not in accordance with the Fixed Principles, to seek to identify causes of changes in demand, and to allocate costs on the basis of who is deemed to be responsible for particular demand changes. Such an approach would lead to inefficient outcomes.

Cost allocation should, to the greatest extent possible, ensure that the customers who cause the consumption of economic resources pay a price that reflects the cost of those resources. This is what ensures customers face the right incentive to consume those resources rather than put them to alternative use. If costs are allocated on the basis of who causes a change in demand as suggested by iiNet, then some customers including iiNet will pay less than the cost of the economic resources they consume, and others more. This would provide an incentive for iiNet to consume

[5] iiNet submission, p 9.

more of those economic resources than is efficient, which would be inconsistent with the object of promoting the long term interests of end users.

In any event, as previously explained, Telstra is not responsible for the forecast change in demand for fixed-line services associated with NBN migration – the NBN was going to be rolled out with or without Telstra's co-operation.[6] Therefore it is not appropriate for Telstra to fully bear the impact of declining demand for fixed-line services associated with NBN migration.

## 1.3 Consistency with the Fixed Principles

iiNet argues that the ACCC adjustment to cost allocation factors is consistent with the Fixed Principles. It is said that the Fixed Principles only requires the allocation of costs between 'various' services to be based on relative usage and does not require that *all* costs be allocated to specific services.[7] As noted above, iiNet also supports the ACCC view that the relevant 'costs' are caused by the NBN and therefore should not be allocated to fixed line services under the Fixed Principles.

Telstra disagrees. For reasons set out in Telstra's July submission, the ACCC's proposed adjustments directly contravene the cost allocation Fixed Principle, the demand Fixed Principle and the RAB roll-forward Fixed Principle.[8]

The response by iiNet does nothing to demonstrate how these concerns may be resolved:

- iiNet's interpretation of the cost allocation Fixed Principle 6.14(a) – that it does not require all costs to be allocated to specific services – would render this principle meaningless. It would imply that costs could be allocated to hypothetical or unspecified services, with the result that the allocation of costs would not reflect relative usage of the network by each service. In particular, if some costs are unallocated, this would mean that the allocations to the services that have been specified would not reflect their relative usage of the network – rather, the allocation of costs to these services would be less than their relative usage.

- Fixed Principle 6.14(d) – which requires the ACCC to consider causal relationships between supplying services and incurring costs – does not support the ACCC's approach, as iiNet suggests. The costs that are being excluded through the ACCC's adjustment to cost allocation factors are not costs that are caused by the NBN – rather, as noted above, these costs are caused by the provision of fixed-line services. Accordingly, the Fixed Principles require these costs to be allocated to users of fixed-line services.

## 1.4 Impact on cost recovery

iiNet does not seek to argue that Telstra will have an opportunity to recover the cost of supplying the declared services, through declared service charges. Rather, it is argued that either Telstra is compensated elsewhere for the shortfall in recovery from the fixed-line services.[9]

While this issue is not relevant to Telstra's ability to recover its costs through declared service prices, it is nonetheless addressed briefly below.

**Telstra's ability to recover the shortfall through the DAs**

iiNet claims that:[10]

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[6] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to ACCC further draft decision, 17 July 2015, p 23.
[7] iiNet submission, p 9.
[8] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to ACCC further draft decision, 17 July 2015, pp 16-21.
[9] iiNet submission, p 10.
[10] iiNet submission, p 10.

- Telstra is receiving payments from NBN Co that are intended to compensate for the effects of the NBN; and

- The amount of those payments is more than sufficient to offset the revenue impact arising from the ACCC's treatment of NBN impacts.

The first of these claims is simply incorrect. Telstra has previously explained (and provided evidence) that payments under the DAs were not intended to (and did not) compensate Telstra for all of the effects of the NBN.[11]

The second of iiNet's claims appears to be no more than an irrelevant observation that the total value of payments expected to be made under the DAs is greater than the revenue impact arising from the ACCC's treatment of NBN impacts in the Further Draft Decision. The fact that Telstra is receiving an amount of revenue elsewhere that is greater than the amount of revenue it is being deprived of through the ACCC's treatment of NBN impacts does not justify the approach taken in the Further Draft Decision.

All evidence before the ACCC demonstrates that Telstra's arrangements with NBN Co and the Government did not contemplate or provide for it to be compensated for the effects of loss of scale economies associated with the NBN rollout. That this is the case was acknowledged by the Department in its own submission to the ACCC.[12]

Therefore the fact remains that Telstra will not have an opportunity to recover the cost of supplying the fixed-line services if the ACCC maintains the adjustment to allocation factors to account for lost scale economies in the final decision.

## 1.5 Perceived generosity to Telstra

iiNet argues that the ACCC adjustment to cost allocation factors is generous to Telstra, since the ACCC has made 'conservative' assumptions about opex in the 'without NBN' scenario.[13] It is claimed that the assumption that opex would be flat in the 'without NBN' scenario is generous, since it ignores scope for efficiency gains and other factors which may put downward pressure on opex.

There is no basis for this assertion. The ACCC's assumption that opex would be flat in a 'without NBN' world is not generous, but rather is entirely arbitrary. iiNet cannot say with any certainty what Telstra's operating expenditure requirement would be in a hypothetical 'without NBN' world, and it certainly cannot be assumed that opex would be declining in this hypothetical scenario. While there are some factors which might put downward pressure on opex over time (e.g. scope for efficiency gains), there are also numerous factors which would put upward pressure on opex (e.g. new customer connections, and increases in rent and electricity costs).

## 1.6 Is the price decline due to exclusion of costs?

Optus argues that the price reduction proposed in the Further Draft Decision is "not due to exclusion of costs". Optus says that the decision to reduce the rates in the FAD by an average 9.6% is largely due to a lower cost of capital.

This is not the case. Between the March Draft Decision and the Further Draft Decision there was in fact a moderate *increase* in the rate of return, and yet the price outcome determined by the ACCC changed considerably – from a 0.7% price reduction to a 9.6% price reduction.

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[11] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to Draft Decision, 1 May 2015, pp 46-50; Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to ACCC further draft decision, 17 July 2015, pp 25-26.
[12] Final access determinations for fixed-line services – primary price terms, Department of Communications submission on the Australian Competition and Consumer Commission's further draft decision, 17 July 2015.
[13] iiNet submission, p 11.

It is clear from the ACCC's Further Draft Decision and the modelling that sits behind this that the primary driver of the large reduction in prices is the ACCC's adoption of a new approach to accounting for 'NBN-induced loss of economies of scale' through adjustments to cost allocators. If the 'NBN scale adjustment' is turned off in the ACCC's model, the price outcome changes from a 9.6% price reduction to a 5.5% price increase.

Indeed the ACCC noted, in the media release accompanying the Further Draft Decision:[14]

> *A number of factors have contributed to the change in the estimated price movement between the March draft decision and this further draft decision. These have not all moved in the same direction and some are more significant than others. By far the most significant factor is the approach taken on NBN effects…*

Thus, it is clear that the ACCC's decision to disallow recovery of [Commercial-in-confidence commences] [Commercial-in-confidence ends] prudent and efficient costs is having a very significant impact on the final price outcome.

[14] ACCC draft Fixed Line Services decision sees one-off uniform fall in access prices of 9.6%, ACCC media release, 29 June 2015.

## 2. Expenditure forecasts

### 2.1 The ACCC-approved expenditure forecasts are not 'excessive' or 'inflated'

Optus characterises the Further Draft Decision as accepting Telstra's "excessive" and "inflated new forecasts", but then making a "pragmatic" adjustment to the cost allocation factors to mitigate this.[15]

In effect, Optus's argument amounts to a claim that the ACCC has accepted wrong and excessive forecasts on the basis that these are balanced by elsewhere refusing Telstra costs which otherwise ought to be recovered. This contention is both wrong and suggests an approach that, had it been the ACCC's approach, would have been highly improper.

The fact is that the ACCC has not simply accepted excessive forecasts on the basis that this generosity will be offset by its decision to exclude costs elsewhere. The ACCC has reviewed the detailed submissions, explanatory material and expert evidence from Telstra in relation to its expenditure forecasts, has undertaken its own review and has formed a judgement as to the prudency and efficiency of Telstra's forecasts, as required by the Fixed Principles.

In large part, the ACCC has accepted that Telstra's forecasts reflect prudent and efficient costs. At no point has the ACCC said that Telstra's forecasts are excessive or inflated or that these have been accepted in order to 'balance' under-recovery in other parts of the model.

### 2.2 iiNet proposed 'top down' method for forecasting capex

iiNet advocates a top-down approach to forecasting capex, based on analysis presented by the ACCC in the Further Draft Decision. iiNet says that the ACCC should use a forecast based on the four-year historical average of actual expenditure, adjusted for NBN rollout, since this is most likely to be nearest to prudent and efficient costs.[16]

iiNet has clearly picked the lowest capex forecast number that appears in the Further Draft Decision, without providing any principled reason why this number ought to be adopted.

Telstra considers that there is no reason why a 'top-down' number based on historical figures should be adopted in place of a robust bottom up forecast, as has been submitted by Telstra and largely accepted by the ACCC. Telstra has demonstrated that its bottom-up forecasting method is robust, and that the forecasts produced by this method are likely to be highly conservative.[17] Telstra has captured historical trends in its bottom up forecasting, but in a more sophisticated and principled way than proposed by iiNet – i.e. at an asset class level, rather than at the aggregate level.

### 2.3 Errors identified by Optus in the FLSM forecast sheets

Optus identifies two minor errors in the FLSM forecasts sheets, relating to incorrect referencing of demand forecasts in the Networks section of the 'Opex Forecasts' sheet and updating required in the inflation assumptions. [18]

Telstra agrees that these are errors and accepts that they should be corrected. We note that the correction of these two errors has a relatively small impact on the overall price outcome.

[15] Optus submission, [1.11] and [2.4].
[16] iiNet submission, p 7.
[17] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to Draft Decision, 1 May 2015, section 4.
[18] Optus submission, [2.18].

## 3. Rate of return

Optus claims that the ACCC has set the rate of return too high. Optus focuses in particular on the equity beta, and argues that an equity beta of 0.7 is too high.

The evidence in fact indicates that the ACCC has under-estimated a number of key rate of return parameters, including the equity beta, and risk premium parameters.

### 3.1 The appropriate equity beta

Optus argues that an equity beta of 0.4 should be applied, based on 'Telstra observed values'.[19] Alternatively, Optus says that correcting the international comparison (removing Spark NZ from this comparison) results in an equity beta of 0.67.[20]

As explained in Telstra's response to the March draft decision, the current empirical evidence, when properly interpreted (i.e. with appropriate adjustment of estimates), shows that Telstra's equity beta is in fact above 0.7. In particular:[21]

- across the relevant international comparator set, the average asset beta (based on the adjusted equity beta estimates published by Bloomberg) is in excess of 0.5. This result does not change even if Spark NZ is removed from the dataset, as suggested by Optus;[22]

- for Telstra, the asset beta is over 0.5.[23]

When re-levered to reflect Telstra's assumed gearing level (40% debt / 60% equity), an asset beta of 0.5 implies an equity beta of around 0.8.

The key reason for the difference between Telstra's estimates and those referred to by Optus is that Telstra's estimates include the adjustment made by Bloomberg to the raw (historical) figures. As explained in Telstra's submission in response to the March draft decision, it is necessary to include this adjustment, in order to ensure that estimates reflect the forward-looking beta (as opposed to the historical beta).[24] It appears that Optus has not taken the Bloomberg adjustment into account, and has instead relied upon the raw (unadjusted) beta estimates from Bloomberg.

### 3.2 Market risk premium

Recent evidence further supports Telstra's view that the ACCC's estimate of the MRP is too low. The ACCC's estimate is inconsistent with:

- Current empirical evidence, including evidence from the AER's own Dividend Growth Model (**DGM**) analysis;

- Views of market experts and policy makers in relation to current market conditions; and

- Recent decisions of other Australian regulators.

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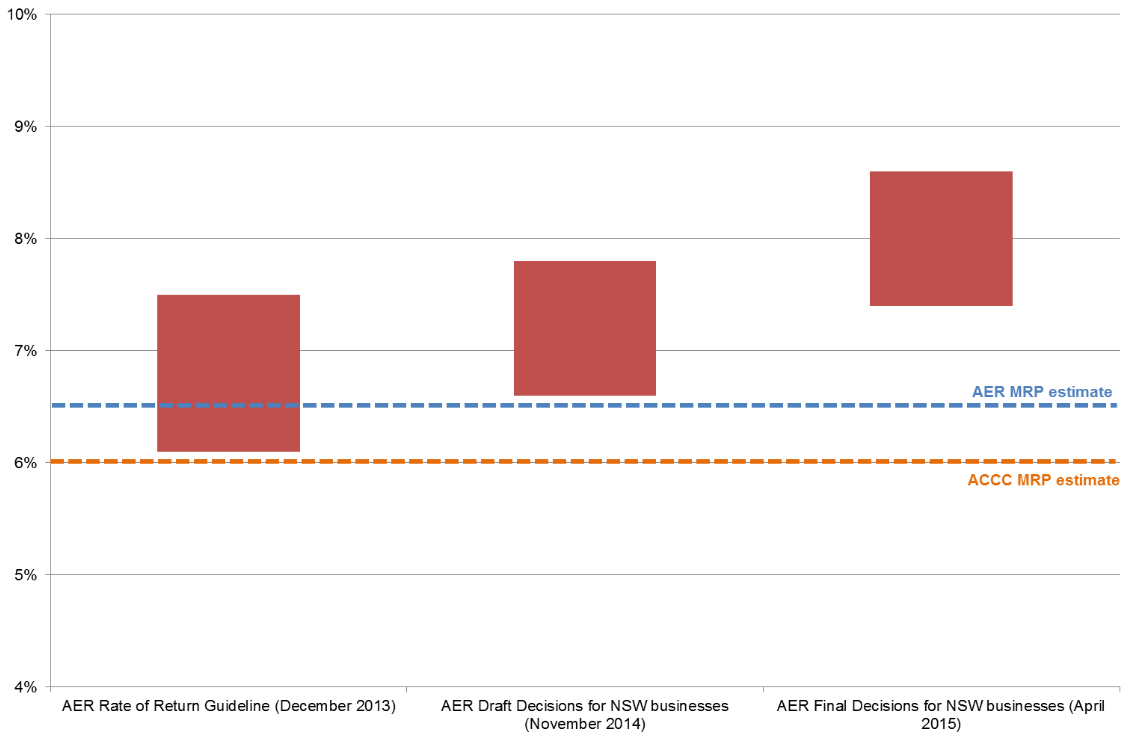
[19] Optus submission, [4.11].
[20] Optus submission, [4.9].
[21] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to Draft Decision, 1 May 2015, pp 158 - 161.
[22] With Spark removed, the average asset beta based on 5 year monthly estimates is 0.5, and based on 5 year weekly estimates it is 0.54 (based on implied asset beta estimates using adjusted equity beta estimates from Bloomberg, per Table 28 of Telstra's response to the March draft decision).
[23] Refer to Table 28 of Telstra's response to the March draft decision, and the accompanying explanation of these calculations.
[24] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to Draft Decision, 1 May 2015, p 159.

Since the March draft decision was published, the AER has updated its DGM analysis. This updated analysis points to increases in the MRP in recent months, and a widening gap between the ACCC's MRP estimate and market realities.

The change in the AER's DGM-based estimates of the MRP between its Rate of Return Guideline (November 2013) and its recent decisions for the NSW electricity businesses (April 2015) is shown in Figure 1. This shows the very large gap between the ACCC's MRP estimate and what is now indicated by the AER's DGM.

**Figure 1: AER DGM-based estimates of the MRP[25]**




It should be noted that the above chart reflects the AER's own estimates of the MRP, using its preferred construction of the DGM and its preferred range of input assumptions. While there may be some disagreement over model inputs, even adopting the AER's preferred model construction and input assumptions, the results clearly indicate that:

- The MRP has significantly increased over the past 18 months; and
- The ACCC's MRP estimate of 6 per cent is now well below that indicated by the AER's DGM analysis.

The fact that risk premiums appear to have increased recently has been observed by leading market experts. For example, Reserve Bank Governor Glenn Stevens noted in a recent speech:[26]

> *…another feature that catches one's eye is that, post-crisis, the earnings yield on listed companies seems to have remained where it has historically been for a long time, even as*

[25] AER, *Better Regulation - Explanatory Statement: Rate of Return Guideline*, December 2013, Appendix E, p 119; AER, *Draft Decision: Ausgrid distribution determination 2015−16 to 2018−19, Attachment 3 – Rate of return*, November 2014, p 3-229; AER, *Final Decision: Ausgrid distribution determination 2015−16 to 2018−19, Attachment 3 – Rate of return*, April 2015, p 3-310.

[26] Glenn Stevens, 'The World Economy and Australia', Address to The American Australian Association luncheon hosted by Goldman Sachs, New York, 21 April 2015.

> *the return on safe assets has collapsed to be close to zero (Graph 2).* ***This seems to imply that the equity risk premium observed ex post has risen even as the risk-free rate has fallen and by about an offsetting amount****. [emphasis added]*

This fact has been taken into account to by most Australian regulators in recent decisions. As shown in Table 1 below, most Australian regulators have adopted an MRP above 6% in recent regulatory decisions.

**Table 1: Recent decisions of Australian regulators in relation to the MRP**

| Regulator | Decision | Date | MRP |
|---|---|---|---|
| IPART | February 2015 WACC parameters update | February 2015 | Current: 7.4% - 9.2%<br><br>Long-term average: 5.5% - 6.5% |
| QCA | Final Report on Gladstone Area Water Board Price Monitoring 2015-2020 | May 2015 | 6.5% |
| AER | Final decision on JGN's access arrangement revisions proposal for the 2015-2020 period | June 2015 | 6.5% |
| ERA | Final Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems | June 2015 | 7.6% |

## 3.3 Debt risk premium

Telstra has previously provided evidence that the ACCC's estimate of the debt risk premium (**DRP**) is too low, and does not reflect the efficient cost of borrowing faced by Telstra.[27]

This evidence does not appear to have been taken into account by the ACCC in the Further Draft Decision.

## 3.4 Conclusion

Contrary to claims made by Optus that the ACCC has set the WACC too high, the evidence in fact indicates that a number of WACC parameters have been under-estimated. In particular, the ACCC's estimates of the equity beta, MRP and DRP are all below what is indicated by current evidence.

[27] Telstra, Public inquiry into final access determinations for fixed line services—primary prices: Response to Draft Decision, 1 May 2015, pp 149 - 154.

# 4. Commencement and expiry of the new FADs

iiNet argues that the new FAD should be backdated to 1 July 2014, and should apply for a four-year term.[28]

Telstra notes that the new FADs cannot be backdated. Since they are to replace existing FADs, the commencement date for the new FADs must be the first day after the existing FADs expire.[29]

[28] iiNet submission, p 14.
[29] CCA, s 152BCF(4).

## Attachment – Summary of responses to Optus and iiNet submissions

| Claim | Ref | Telstra response |
|---|---|---|
| Price decline not due to exclusion of costs | Optus, p 3 | It is clear on the face of the ACCC's FLSM that: (a) a portion of the cost of supplying the declared services is excluded from the price calculation ([Commercial-in-confidence commences] [Commercial-in-confidence ends] is excluded just through the adjustment to allocation factors); and (b) this exclusion of costs leads to a negative price change outcome. Without the adjustment to allocation factors the ACCC's FLSM delivers a positive price change outcome (+5.5%).<br><br>Refer to section 1.6 above. |
| Price decline driven by a lower cost of capital | Optus, p 3 | As noted above, it is clear that the principal driver of the change in price outcome between the March draft decision and the Further Draft Decision is the ACCC's decision to adjust cost allocators to remove the effect of NBN-induced loss of economies of scale.<br><br>Refer to section 1.6 above. |
| It is Telstra's agreement with NBN Co that has led to 'the increase in costs' | iiNet, p 13 | There are two problems with this statement:<br><br>• There is no increase in costs. In fact, the cost of supplying the declared fixed-line services is forecast to decline significantly over the next four years, due to reductions in forecast operating and capital expenditure requirements. What is being referred to is a moderate increase in the *unit* cost of supply, due to the fact that demand will be declining faster than costs.<br><br>• The forecast decline in demand (which is a key driver of the increase in unit costs) is due to the Government's NBN policy. It is not due to Telstra's agreement with NBN Co. As the Government made clear at the time, the NBN was going to be rolled out with or without an agreement with Telstra. |

| Claim | Ref | Telstra response |
|---|---|---|
| Telstra had an opportunity to recover from NBN Co any increase in costs that result from NBN migration, and did in fact do so | iiNet, p 13 | This is untrue. Refer to section 1.4 above and section 1.4 of Telstra's response to the Further Draft Decision. |
| The approach in the Further Draft Decision does not lead to Telstra failing to recover its prudent and efficient costs of supply declared services, because Telstra is compensated for the 'relevant NBN costs' (including 'costs' associated with loss of economies of scale) through the DAs | iiNet, pp 9-10 | Implicit in this statement appears to be an acknowledgement that the ACCC has excluded some costs from the price calculation. The two categories of 'relevant NBN costs' identified by iiNet as being excluded are NBN related expenditure and 'the cost of loss of economies of scale' (p 9).<br><br>It should be noted that 'the cost of loss of economies of scale' is not a separate category of cost that is 'incremental to the NBN'. The costs that are being excluded as 'costs of loss of economies of scale' are costs associated with the supply of declared services.<br><br>As explained in section 1.4 above and section 1.4 of Telstra's response to the Further Draft Decision, Telstra is not compensated for the exclusion of these 'costs' through the DAs.<br><br>Since Telstra is not otherwise compensated for the exclusion of these 'costs', it must be that Telstra will not have an opportunity to recover the costs of supplying the declared services. |
| The approach in the Further Draft Decision is consistent with the Fixed Principles | iiNet, pp 8-9 | Telstra has explained in detail how the ACCC's adjustments breach the Fixed Principles. iiNet's submission does not resolve this issue.<br><br>Refer to section 1.3 above and section 1.3 of Telstra's response to the Further Draft Decision. |
| The approach in the Further Draft Decision is generous to Telstra, because opex is assumed to be flat in the non-NBN world | iiNet, p 11 | There is no basis for this claim.<br><br>Refer to section 1.5 above. |

| Claim | Ref | Telstra response |
|---|---|---|
| The approach in the Further Draft Decision is merely an implementation of the October 2014 Position Statement | Optus, p 9 | This is a mischaracterisation of the Position Statement. The Position Statement did not foreshadow an adjustment to the total costs that Telstra would be able to recover. The Position Statement dealt specifically with adjustments to the RAB to account for assets affected by NBN rollout and adjustments to allocators to ensure that NBN Co's use of the network is properly accounted for.<br><br>Refer to section 1.1 above. |
| The ACCC has accepted 'inflated new forecasts' that are 'excessive' | Optus, p 4, 5 | The ACCC has accepted that Telstra's forecasts of operating and capital expenditure reflect prudent and efficient costs. |
| The LTIE is served by lower prices | iiNet, p 12 | The LTIE is served by prices that reflect the efficient cost of supplying the declared services. |
| It cannot be consistent with the LTIE to increase prices for legacy services simply because Telstra's cost model dictates this. | iiNet, p 12 | As noted above, the LTIE is served by prices that reflect the efficient cost of supplying the declared services. Therefore, if the ACCC's assessment is that the efficient (unit) cost of supplying the fixed line services has increased, then it would promote the LTIE to increase prices in line with this increase in unit costs. |
| The new FAD can (and should) be backdated to 1 July 2014 | iiNet, p 14 | The new FADs cannot be backdated. Since they are to replace existing FADs, the commencement date for the new FADs must be the first day after the existing FADs expire. |