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

Further Draft Decision – Outstanding Issues

June 2015

Submission by iiNet Limited

Public version

1. Introduction

The Australian Competition and Consumer Commission (**ACCC**) is currently undertaking public inquiries into making new final access determinations (**FADs**) for seven fixed line services (**the Declared Services**).[1]

In July 2014 the ACCC released a discussion paper about the primary price terms for the FADs for the Declared Services (**the Discussion Paper**). In October 2014 the ACCC released a position statement on the treatment of the arrangements between Telstra and NBN Co (**the NBN Position Statement**). In March 2015 the ACCC issued a draft decision entitled: *Public inquiry into final access determinations for fixed line service — primary price terms* (**the March Draft Decision**). The March Draft Decision related to:

- the primary price terms for the Declared Services;
- one supplementary price term;
- the scope of the standard access obligations (**SAOs**) for the Declared Services.

The non-price terms and other supplementary prices to be included in the Declared Services FADs are subject to a separate consultation and draft decision.

Although the ACCC reached conclusions on a large number of issues in the March Draft Decision, conclusions on some key issues were left outstanding. The ACCC has released a further draft decision that addresses those outstanding issues (**the June Draft Decision**).

The ACCC is seeking submissions in response to the June Draft Decision. iiNet Limited (**iiNet**) welcomes the opportunity to respond to the June Draft Decision.

Please note this submission contains confidential information which has been marked as [c-i-c] and highlighted in yellow.

2. Scope and structure of this submission

The June Draft Decision considers the following issues:

- the prudent and efficient level of operating expenditure to be included in the charges for regulated services in the next regulatory period;
- the prudent and efficient level of capital expenditure to be included in the charges for regulated services in the next regulatory period;
- whether regulated charges should rise as a result of higher unit costs caused by declining demand as services are disconnected from Telstra's fixed line network as the National Broadband Network (**NBN**) rollout proceeds; and

[1] These are: the Local Call Service (**LCS**), Line Sharing Service (**LSS**), the Fixed Originating Access Service (**FOAS**), the Fixed Terminating Access Service (**FTAS**), the Unconditioned Local Loop Service (**ULLS**) and the Wholesale Line Rental Service (**WLR**) and the Wholesale ADSL service (**WDSL**).

- whether methods, assumptions and inputs proposed by Telstra for Telstra's cost allocation framework (**CAF**) are appropriate.

This submission provides iiNet's views on the approach the ACCC has taken to each of the Outstanding Issues. This submission also provides:

- iiNet's overall conclusion on the June Draft Decision.
- iiNet's view on commencement and expiry of the FAD.

3. Key messages

If the March Draft Decision as adjusted by the June Draft Decision is implemented, this will lead to a uniform price reduction of 9.6%.[2] iiNet believes that this price reduction is justified and will promote the long term interests of end users (**LTIE**) because the economic value of Telstra's legacy network is declining due to the NBN. Overall, it appears to iiNet that the June Draft Decision has struck a reasonable balance between the competing arguments from Telstra and access seekers and this balance delivers an outcome that is consistent with the statutory criteria and which should be maintained. Accordingly, iiNet believes that the ACCC should:

- resist any attempts by Telstra to include revised expenditure forecasts that will lead to a different outcome; and
- conclude this long standing inquiry as soon as possible by making a FAD that delivers an outcome consistent with the June Draft Decision.

For the reasons given in section 9 below, iiNet also believes that it would be appropriate for the ACCC to backdate the new FAD to 1 July 2014.

4. The prudent and efficient level of operating expenditure to be included in the charges for regulated services in the next regulatory period

The ACCC must not accept Telstra's forecast operating expenditure unless the ACCC is satisfied that Telstra's forecast operating expenditure represents prudent and efficient costs.[3] At the time of making the March Draft Decision, the ACCC was unable to form a view on whether Telstra's forecast operating expenditure represented prudent and efficient costs. In particular, the ACCC was concerned that Telstra had not provided a transparent and verifiable cost allocation approach that permitted sufficient scrutiny of:

- the traceability of costs from asset class to general ledger;
- whether costs incurred are relevant to the provision of fixed services; and
- how forecast operating expenditures respond to changes in forecast demand.[4]

[2] http://www.accc.gov.au/media-release/accc-draft-fixed-line-services-decision-sees-one-off-uniform-fall-in-access-prices-of-96
[3] Fixed Principle 6.9.
[4] March Draft Decision at p.29.

In the June Draft Decision the ACCC has formed the view that further information received from Telstra sufficiently addresses the concerns regarding the transparency of Telstra's operating expenditure forecasts so that, subject to some outstanding issues and adjustments, the ACCC is able to accept Telstra's May 2015 operating expenditure forecasts as representing prudent and efficient costs.[5]

iiNet acknowledges that Telstra has provided voluminous information in response to the March Draft Decision and that a significant amount of this information is intended to address the concerns raised in the March Draft Decision relating to the lack of transparency of Telstra's forecast expenditure. Nevertheless, iiNet continues to have concerns that fundamental information asymmetries mean that much of the information provided by Telstra is accepted at face value. In this regard iiNet notes the following comments by the ACCC in the June Draft Decision:[6]

> *There is considerable uncertainty and variation around Telstra’s forecast operating expenditures. Since October 2014, Telstra has provided a number of iterations and revisions to its operating expenditure forecasts. Telstra has demonstrated that it has considerable discretion in choosing the allocation methods to estimate its base year operating expenditure and its forecast operating expenditure. Such discretion has material effects on its forecast of operating expenditures. Telstra has signalled it may seek to include more FLSM-related operating expenditures prior to the final decision.*
>
> *Scope for such discretion may elevate the risk of Telstra proposing to include imprudent and inefficient expenditures in the FLSM.*

[…]

> *In its March submission on the mapping of expenditures, Telstra provided comprehensive information on its capital and propex projects by IMC code. The absolute amounts of propex spends are hardcoded extracts from Telstra’s expenditure accounts. Since Telstra has discretion on the allocation of its expenditures to FLSM asset classes and what information is imparted, the ACCC could only scrutinise these accounts on a limited basis.*

These comments take on added significance when viewed in the context of Telstra having incentives to inflate the costs that it allocates to fixed line services for the purpose of regulated pricing.[7]

iiNet is concerned that Telstra's forecast expenditure has been something of a movable feast with a number of different iterations being provided during the course of the FAD inquiry. iiNet submits that it would be appropriate for Telstra's forecast operating expenditure of January 2015 to represent a ceiling because:

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[5] The outstanding issues relate to Telstra providing further information in relation to activity-based management code information to support its approach for allocating indirect costs associated with Customer Service Delivery (fault reporting activity to FLS, to explain what property rental costs are incurred by the FLS and to justify the re-allocation of the majority of propex costs to the ITS cost centre – June Draft Decision at p.19-20.

[6] June Draft Decision at pp35 and 41.

[7] Ibid at p.29.

- Telstra submitted revised forecast operating expenditure in January 2015 which at that time Telstra represented as being prudent and efficient;

- information asymmetries mean that Telstra has considerable discretion in choosing allocation methods that have material effects on the amount of forecast operating expenditure that is allocated to the fixed line services; and

- Telstra has incentives to inflate the costs that it allocates to fixed line services for the purpose of regulated pricing.

iiNet submits that Telstra should not be permitted to use a request for transparency as an opportunity to adjust its forecast operating expenditure upwards, otherwise Telstra will have no incentive to provide accurate and transparent forecasts. Telstra being able to re-submit its expenditure forecasts any time it feels like it, together with the significant information asymmetries that give rise to the discretions discussed in the extracts above, provide significant opportunity for Telstra to game the process – i.e. Telstra can simply submit a forecast that is acceptable to it in the first instance and if that forecast is questioned, Telstra can submit a higher forecast in the guise of being more 'thorough and transparent'.[8] Therefore, iiNet submits that if the ACCC deems it appropriate to revisit the issue of forecast operating expenditure due to Telstra submitting yet further revised forecast operating expenditure, the ACCC should use the January 2015 forecast operating expenditure (subject to appropriate adjustments being made to remove NBN propex and any other inappropriate inclusions or inflations) for the purposes of the fixed line services model (**FLSM**).

5. The prudent and efficient level of capital expenditure to be included in the charges for regulated services in the next regulatory period

The ACCC came to the following conclusions in the March Draft Decision regarding Telstra's forecast capital expenditure:[9]

- NBN specific capital expenditure should be excluded from the cost base for the fixed line services.

- The ACCC was not able to form a view on:

  - Telstra's capital expenditure forecast methodology;
  - the prudency and efficiency of including in capital expenditure forecasts demand-related capital expenditure for transmission assets; and
  - the prudency and efficiency of including certain investment management committee (IMC) related capital projects in the forecast capital expenditure,

  (for ease of expression referred to collectively as **the Outstanding Issues**).

As regards NBN specific capital expenditure, the ACCC has maintained its view that these costs should be excluded because the ACCC considers that it would be inappropriate to recover from fixed line access seekers, or other users of the fixed line network, costs of

[8] In this regard iiNet notes that although Telstra's reviews have led to removal of some costs, the result of the review is a **[c-i-c starts] [c-i-c ends]**

[9] June Draft Decision at p.47.

network investments which would not be required in the absence of the NBN roll out.[10] iiNet agrees with the ACCC's reasoning on this issue.[11] iiNet notes Telstra's arguments about the application of the Fixed Principles to this issue.[12] iiNet simply observes that it is difficult to see how the ACCC's approach on this issue could be found to be inconsistent with the Fixed Principles because the Fixed Principles do not prevent the ACCC from applying a threshold test of relevancy based on cost causality.[13] However, even if the ACCC and iiNet were to be wrong about this, it would be open to the ACCC to achieve the same result by including the NBN specific capital expenditure in the FLSM and then adjusting the allocation factors so that access seekers do not bear any of this cost. Furthermore, regardless of the position under the Fixed Principles, it should be acknowledged that the ACCC's approach is consistent with the LTIE because it cannot promote the LTIE to require users of fixed line legacy services to pay higher prices in order to recover the cost of investments that are for the specific purpose of the NBN rollout. Accordingly, iiNet believes that the ACCC's draft decision on this issue is sound and robust and is in accordance with the Fixed Principles and the LTIE.

As regards the Outstanding Issues, iiNet notes that the March Draft Decision was based on information received from Telstra up to 30 January 2015, including Telstra's expenditure forecast submitted in January 2015. However, Telstra provided revised forecasts in May 2015. iiNet notes that on the basis of Telstra's May 2015 forecasts, other information provided by Telstra since the March Draft Decision and consideration of the ACCC's own alternative forecasts, the ACCC has reached the draft decision that Telstra's approach to the Outstanding Issues as represented in the May 2015 forecasts reflects prudent and efficient costs.

iiNet notes that on the basis of the figures in the June Draft Decision, when NBN related capex is excluded, the May 2015 forecast operating expenditure is [**c-i-c starts**] [**c-i-c ends**]. iiNet has similar information asymmetry and transparency concerns relating to Telstra's forecast capital expenditure as iiNet has with Telstra's forecast operating expenditure discussed in the previous section of this submission. In this regard, iiNet notes that in considering the appropriateness of Telstra's methodology for forecast capital expenditure, the ACCC has undertaken, by way of a sanity check, an analysis that involves scaling down capital expenditure in line with the NBN rollout using the following two alternative base level starting scenarios:[14]

- adoption of Telstra's 2014–15 capital expenditure forecast as the base expenditure for 2015–16 to 2018–19; and

- adoption of the average of Telstra's historical capital expenditure (from 2011–12 to 2014–15) as the base expenditure for 2015–16 to 2018–19.

iiNet submits that there is no prospect of a scenario based on historical costs delivering an outcome that is below what is prudent and efficient – i.e. due to on-going incentives to increase efficiencies, a base year based on historical costs is more likely to represent the

[10] Ibid at p.49.
[11] Note the considerations discussed here are also relevant to the removal of NBN related propex.
[12] Telstra submission in response to the March Draft Decision, at p.25.
[13] In this regard, iiNet notes that Fixed Principle 6.10(e) allows the ACCC have regard to any matter relevant to whether the forecast capital expenditures reflect prudent and efficient costs.
[14] It should be noted that iiNet is proceeding on the basis of the conclusions expressed in the June Draft Decision relating to these two base scenarios – iiNet has not verified the outcome of these scenarios.

higher end of any scale rather than the lower end. Therefore, the fact that [**c-i-c starts**] [**c-i-c ends**]. In light of this, iiNet submits that adoption of the [**c-i-c starts**] [**c-i-c ends**] would be the most likely of the scenarios considered by the ACCC to be nearest to prudent and efficient costs.

6. Whether regulated charges should rise as a result of higher unit costs caused by declining demand as services are disconnected from Telstra's fixed line network as the National Broadband Network (NBN) rollout proceeds

The rollout of the NBN and the arrangements between NBN Co and Telstra clearly have an impact on the setting of prices for the Declared Services. There are various ways that this impact can be dealt with.[15] To the ACCC's credit, the ACCC has sought, as far as it is able, to provide certainty to industry as soon as possible as regards the approach the ACCC would take to the impact of the NBN on setting prices for the Declared Services. To this end, the ACCC released the NBN Position Statement in October 2014.

The NBN Position Statement made it clear that the ACCC would not consider the value of the NBN payments as such but would instead seek to give regulatory value to account for the impacts of the arrangements between Telstra and NBN Co. In the March Draft Decision the ACCC stated that it would implement the regulatory values approach as follows:[16]

- assets sold to NBN would be treated as asset disposals and removed from the RAB at their regulatory value;
- to the extent that NBN uses assets that are also used to provide declared services, this would be accounted for in the cost allocation framework of the FLSM;
- assets that are decommissioned as a result of NBN migration would be treated as disposals and removed from the RAB at their regulatory value, and
- an appropriate share of assets utilised to a lesser extent as a result of NBN migration would be removed from the regulated cost base based on regulatory values.

The March Draft Decision also raised the issue of how to deal with the loss of economies of scale due to the NBN. The ACCC raised the issue in the following terms:[17]

> *The ACCC agrees with WIK-Consult that loss of economies of scale in the provision of fixed line services is likely to be predominantly incremental to the NBN. Further, the ACCC considers that access seekers should not incur higher charges for fixed line services as a consequence of the decision by Telstra regarding the future of its copper network. The ACCC is still considering this issue and, in particular, how it will identify the increase in unit operating costs due to NBN-induced loss of economies of scale and density. The ACCC invites comments from stakeholders on this issue in submissions.*

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[15] Possible ways of dealing with the impacts of the NBN were suggested in early submissions provided to the ACCC in March 2014 by Frontier Economics (on behalf of iiNet and TPG) and NERA (on behalf of Optus).
[16] As summarised in the June Draft Decision, at p.68.
[17] March Draft Decision, at p.141.

In the June Draft Decision, the ACCC has confirmed the approach to the treatment of the arrangements between Telstra and NBN Co that the ACCC took in the March Draft Decision. The ACCC has also set out how it intends to deal with the issue of loss of economies of scale due to the NBN. In summary this is as follows:[18]

- 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.

- For assets that become progressively under-utilised as a result of NBN migration, adjustments are made to cost allocation factors to ensure that the increased unit costs associated with this under-utilisation are not allocated to fixed line services.

- In order to estimate the unit costs that would result if NBN-induced under-utilisation did not occur, the ACCC has made adjustments to the allocation factors that have the effect of holding base year operating expenditure forecasts constant in real terms over the regulatory period.[19]

iiNet makes the following points in response to the ACCC's approach to the impacts of the NBN in the June Draft Decision:

- The ACCC's approach is consistent with the Fixed Principles.

- The ACCC's approach to taking into account the arrangements between Telstra and NBN Co does not lead to Telstra failing to recover its prudent and efficient costs of supplying the Declared Services.

- The ACCC has been generous to Telstra.

Each of these points is considered in turn.

The ACCC's approach is consistent with the Fixed Principles

The ACCC's approach to assets that become redundant due to the NBN is to remove such assets from the RAB on the basis of an asset disposal having occurred. The Fixed Principles clearly allow the RAB to be reduced on the basis of asset disposals.[20] As the Fixed Principles do not provide any definition of the term 'disposal', iiNet agrees with the ACCC's view that the term 'disposal' should be given its ordinary meaning.

iiNet notes that the ACCC relevantly refers to the Australian Accounting Standards Board’s AASB 116 which regards an asset as being disposed of at the end of its useful life. This can include where the asset becomes technically or commercially obsolete.[21] iiNet believes that Telstra's arguments that such an approach is inconsistent with the Fixed Principles are without merit because Telstra unreasonably restricts the definition of asset 'disposal' to a

[18] June Draft Decision, at p73 and p76.
[19] i.e. the lack of responsiveness of Network, ITS and TSO operation expenditures to migration of SIOs to the NBN is captured by that adjustment – June Draft Decision at p.35.
[20] Fixed Principle 6.7(a).
[21] June Draft Decision, at p.74.

situation where the asset has been sold.[22] As the ACCC rightly points out, the accepted meaning of the term 'disposal' is broader than this and comfortably includes the situation of commercial and technical obsolescence that arises from the move from Telstra's legacy network to the NBN.

As regards the ACCC's adjustments to the cost allocation factors, Fixed Principle 6.14(a) only requires that the allocation of costs between 'various' services be done on the basis of relative usage. Fixed Principle 6.14(a) does not require that all costs be allocated to specific services. Furthermore, Fixed Principle 6.14(d) requires the ACCC to consider causal relationships between supplying services and incurring costs. As rightly identified by the ACCC, 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.[23] Therefore, adjusting the cost allocation factors in the way the ACCC has done to avoid access seekers bearing costs that they do not cause is entirely consistent with the Fixed Principles.

The ACCC's approach to taking into account the arrangements between Telstra and NBN Co does not lead to Telstra failing to recover its prudent and efficient costs of supplying the Declared Services

iiNet notes that Telstra states the following in its response to the March Draft Decision:[24]

> *Telstra's shareholders did not approve the commercial arrangements with NBN Co on the basis that Telstra would be fully compensated for the economic effects of the NBN transition*.

iiNet submits that when considering the 'economic effects of the NBN transition' on Telstra, it is important to keep in mind the distinction between:

- the cost to Telstra of the loss of incumbent status; and
- the cost of NBN related expenditure that Telstra has included in its cost allocation framework and which has either been excluded by the ACCC or left in the FLSM but allocated away from access seekers (including the cost of the loss of economies of scale caused by the NBN) – for ease of expression referred to as the **Relevant NBN Costs**.

As regards the value of the loss of incumbent status, it may be that, as implied in the quote above, the payments Telstra is receiving from NBN Co do not completely compensate Telstra for the loss of incumbent status. iiNet is not in a position to form a view on this issue. iiNet submits that it is not necessary to form a view on this issue because it is clearly irrelevant to the determination of prices for the Declared Services because it is not the role of access pricing to seek to ensure that Telstra is fully compensated for the loss of incumbent status as a result of the NBN.

[22] Telstra submission in response to the March Draft Decision, at pp.39-40.
[23] June Draft Decision, at p.76.
[24] Telstra submission in response to the March Draft Decision, at p.57.

As regards Relevant NBN Costs, the issue of how Relevant NBN Costs are treated is clearly relevant to the ACCC's consideration of access pricing. iiNet agrees with the ACCC that on the basis of cost causation, the Relevant NBN Costs cannot legitimately be attributed to access seekers.[25] iiNet believes that the ACCC's reasoning in this regard is sound and in accordance with the Fixed Principles and the applicable statutory criteria. iiNet also agrees with the following points made by the ACCC in the June Draft Decision:[26]

- 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 assets; and

- Telstra possessed significant bargaining power in negotiations with NBN Co and the Government.

iiNet submits that a further point that weighs in favour of the ACCC's approach to the Relevant NBN Costs is that there is no prospect of the ACCC's approach resulting in Telstra not being able to recover the Relevant NBN Costs because:

- Telstra is receiving payments from NBN Co that are intended to compensate Telstra 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 approach to the Relevant NBN Costs.[27]

On the contrary, if the ACCC did allocate any of the Relevant NBN Costs to access seekers, there would be clear double recovery by Telstra. Telstra's submissions on this issue appear to iiNet to be clearly lacking in merit because they appear to conflate the issue of recovering the cost of Telstra's lost incumbency with the issue of recovering the Relevant NBN Costs. Furthermore, iiNet believes that Telstra's attempted portrayal of itself as a passive victim of Government policy[28] is somewhat inconsistent with the view of its former CEO on the position Telstra was in at the relevant time. Mr Thodey put the position thus:[29]

> *There ain't another telco in the world that would be compensated for decline in margin and market share in their PTSN business*

[25] See for example, June Draft Decision, at p.71 relating specifically to the issue of loss of economies of scale caused by the NBN.
[26] June Draft Decision, at p.73.
[27] Telstra's estimate of the revenue impact of the Relevant NBN Costs as relevant to the March Draft Decision is set out at p.37 of Telstra's Response to the March Draft Decision. Frontier Economics has estimated the payments from NBN Co to Telstra being worth $17 billion in pre-tax 2013 dollars - *Frontier Economics Payments between NBN Co and Telstra and prices for the declared fixed line services a Report Prepared For Herbert Geer March 2014*, at p.iii. Although Telstra's response to the March Draft Decision does not include a quantification of the impacts of the June Draft Decision as it relates to the Relevant NBN Costs, it is clear that, given the scale of the payments from NBN Co, the revenue impact arising from the Relevant NBN Costs will be well below the amount Telstra is receiving from NBN Co.
[28] Telstra response to March Draft Decision, at p.45.
[29] Australian Financial Review, 27 June 2011.

The ACCC has been generous to Telstra

iiNet believes that the implementation of the ACCC's approach to the impacts of the NBN is generous to Telstra. As noted by the ACCC (emphasis added):[30]

> *The ACCC considers that the adjustments it has made to allocation factors is a conservative method of adjusting for the costs associated with lost economies of scale caused by NBN migration. The principal driver of regulated revenues over the next regulatory period is operating expenditure forecasts. As noted above, in order to estimate the unit costs that would result if NBN-induced under-utilisation did not occur, the ACCC has held base year operating expenditure forecasts constant in real terms over the period.* ***Assuming constant base year operating expenditure from 2013-14 to 2018-19 ignores any efficiency gains that are achieved over the regulatory period, as well as any reduction in operating costs that may result from the forecast fall in demand for fixed line services that is unrelated to NBN migration.***

Furthermore, as pointed out in sections 4 and 5 above, the ACCC has adopted expenditure forecasts that are, in iiNet's view, also generous to Telstra.

7. Whether methods, assumptions and inputs proposed by Telstra for Telstra's cost allocation framework (CAF) are appropriate

Telstra's cost allocation framework is based on information that is obtained or derived from internal Telstra databases over which the ACCC and access seekers have no visibility.[31] Furthermore, the ACCC's independent consultant WIK Consulting has raised concerns about Telstra's cost allocation framework.[32] In light of this, iiNet believes that it is crucial that the methods, assumptions and inputs used by Telstra in its cost allocation framework are subject to a sufficient degree of independent scrutiny. Accordingly, iiNet believes it was wholly appropriate for the ACCC to engage Analysis Mason to review Telstra's cost allocation framework. In the time available, iiNet has not been able to undertaking a detailed assessment of Analysis Mason's recommendations and to verify whether all of Analysis Mason's detailed conclusions are correct. However, in broad terms, it appears to iiNet that Analysis Mason's recommendations as implemented by the ACCC in the June Draft Decision are based on appropriate objectives (including consistency with the Fixed Principles and promotion of the LTIE) and sound reasoning.

[30] June Draft Decision, at p.76.
[31] March Draft Decision, at p.155.
[32] Ibid.

8. iiNet's overall conclusion on the June Draft Decision

As previously stated by iiNet, there are only three possible outcomes to this inquiry:

- access prices go up;
- access prices stay the same; or
- access prices go down.

iiNet notes that if the March Draft Decision as adjusted by the June Draft Decision is implemented, this will lead to a uniform price reduction of 9.6%.[33] iiNet submits that a price reduction of this level is appropriate when put in its relevant context. The position is neatly summarised by the ACCC's independent consultant:[34]

> *increasing prices for a legacy infrastructure is not in line with the economic value of the infrastructure which is not increasing but decreasing due to technological change.*

iiNet notes that Telstra is essentially arguing for a price increase on the basis of an increase in unit costs due to the migration to the NBN which results from the application of Telstra's own cost model over which Telstra has significant discretion to determine the inputs and allocation factors. iiNet submits that there are two basic reasons why Telstra's approach lacks merit. Firstly, as rightly identified by the ACCC, the increase in costs caused by the NBN (including the increase in unit costs caused by a loss of economies of scale caused by the NBN) are not caused by Telstra's supply of the Declared Services but are caused by Telstra's agreements with NBN Co. Therefore, these NBN costs are not costs that can legitimately be attributed to access seekers. Secondly, it appears clear that, as a matter of fact, the payments Telstra is receiving from NBN Co will more than offset any NBN costs which the ACCC has either excluded or removed from the FLSM or not allocated to access seekers. Therefore, there is no prospect of Telstra not being able to recover the relevant costs.

The statutory test that the ACCC must apply includes consideration of the LTIE as well as the legitimate business interests of Telstra and the interests of access seekers. As regards the LTIE, as noted by the Australian Competition Tribunal:[35]

> *the interests of end-users lie in obtaining lower prices (than would otherwise be the case), increased quality of service and increased diversity and scope in product offerings.*

iiNet submits that it cannot be consistent with the LTIE to increase prices for legacy services simply because Telstra's costs model dictates this.

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[33] http://www.accc.gov.au/media-release/accc-draft-fixed-line-services-decision-sees-one-off-uniform-fall-in-access-prices-of-96

[34] Wik Consult - Assessment on the efficiency and prudency of Telstra's expenditure forecasts 5 March 2015, at p.127.

[35] *Re Seven Network Limited (No 4)* [2004] ACompT 11, at [120]

As regards balancing Telstra's legitimate business interests with the interests of access seekers, it would not be reasonable for access seekers to bear any increase in costs caused by the NBN because:

- it is Telstra's agreement with NBN Co that has led to the increase in costs; and

- Telstra has had an opportunity to recover from NBN Co any increase in costs that result from the migration to the NBN (and as discussed in section 6 above, Telstra will in fact do so).

Given that Telstra engineered a costs model that delivered a significant price increase, iiNet believes that the ACCC must resist the inevitable pressure that Telstra will put on the ACCC to make changes to the ACCC's Draft Decision that will lead to a less significant price decrease or, if Telstra has its way, a price increase. This will likely include revised expenditure forecasts which, due to the severe information asymmetry between Telstra and everyone else, cannot be verified to any satisfactory degree. In this regard, it is worth noting that, as an acknowledgement of the severe information asymmetry that exists, there are justifiable changes the ACCC could make that would lead to a larger price reduction. These changes include:

- Adopting the January 2015 forecast operating expenditure (subject to appropriate adjustments being made to remove NBN propex and any other inappropriate inclusions or inflations) – as discussed in section 4 above.

- Adopting the average of Telstra's historical capital expenditure (from 2011–12 to 2014–15) as the base expenditure for 2015–16 to 2018–19 – as discussed in section 5 above.

- Taking into account efficiency gains when calculating unit costs for operating expenditure as well as any reduction in operating costs that may result from the forecast fall in demand for fixed line services that is unrelated to NBN migration – as discussed in section 6 above.

Overall, it appears to iiNet that the June Draft Decision has struck a reasonable balance between the competing arguments from Telstra and access seekers and this balance delivers an outcome that is consistent with the statutory criteria and which should be maintained. Therefore, iiNet believes that the ACCC should conclude this long standing inquiry as soon as possible by making a FAD that delivers an outcome consistent with the June Draft Decision. iiNet's views on the start date and duration of the FAD are set out in section 9 below.

9. Commencement and expiry of the FAD

Telstra has submitted expenditure forecasts and a costs model which lack transparency. Despite the obvious conclusion that prices for legacy services should be falling, Telstra has delivered expenditure forecasts and a costs model which lead to a significant increase in prices. Scrutiny of Telstra's forecasts and costs model by the ACCC and access seekers has taken a significant amount of time. Furthermore, as identified by Frontier Economics,[36] if the current FAD is applied until the new FAD comes into force, there will be a large over recovery by Telstra of Telstra's operating costs for the year 2014-15. In light of these facts,

[36] Frontier Economics submission in response to the March Draft Decision, at section 2.1.1.

iiNet submits that there would be merit in the new FAD being backdated to 1 July 2014 (i.e. to the end of the previous regulatory period).

As regards expiry of the FAD, iiNet's preference would be for a four year term. That said, iiNet notes the ACCC's view in the March Draft Decision that it may be appropriate to include a 'trigger and review' mechanism to deal with uncertainty relating to the NBN rollout.[37] iiNet considers such an approach to be sensible.

iiNet Limited
17 July 2015

[37] March Draft Decision, at p.159.