



Australian
Competition &
Consumer
Commission

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

Further Draft Decision – Outstanding Issues

June 2015



Australian Competition and Consumer Commission

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List of abbreviations and acronyms

ACCC	Australian Competition and Consumer Commission
ADSL	asymmetric digital subscriber line
AER	Australian Energy Regulator
AGVC	aggregating virtual circuit
BBM	Building Block Model
BBM RKR	Building Block Model Record Keeping Rule
CAN	customer access network
CCA	<i>Competition and Consumer Act 2010</i>
c-i-c	commercial in confidence
CPI	consumer price index
CSP	carriage service provider
DSL	digital subscriber line
DSLAM	digital subscriber line access multiplexer
DTCS	domestic transmission capacity service
ESAs	exchange service areas
FAC	fully allocated cost
FAD	final access determination
FLSM	Fixed Line Services Model
FOAS	fixed originating access service
FTAS	fixed terminating access service
FTTN	fibre-to-the-node
FOTP	fibre-to-the-premises
HFC	hybrid fibre coaxial
IAD	interim access determination
IIC	internal interconnect cable
IMC	investment management committee
LCS	local carriage service
LSS	line sharing service
LTIE	long term interests of end-users
MDF	main distribution frame

MOU	minutes of use
MTAS	mobile terminating access service
MTM	multi-technology-mix
NBN	National Broadband Network
PAC	partially allocated cost
PoI	Points of interconnect
POTS	traditional voice-only services supplied over Telstra's PSTN
PSTN	public switched telephone network
PSTN OA	public switched telephone network originating access service
PSTN TA	public switched telephone network terminating access service
RAB	regulatory asset base
RAF	regulatory accounting framework
RKR	record keeping rule
SIOs	services in operation
TEBA	Telstra Equipment Building Access
ULLS	unconditioned local loop service
VLAN	virtual local area network
WACC	weighted average cost of capital
WLR	wholesale line rental

Glossary

Access determination	Written determinations made by the ACCC relating to access to a declared service after conducting a public inquiry; specifying any or all of the terms and conditions for compliance with any or all of the standard access obligations.
access seeker	Telecommunications companies that seek access to a declared service (that is, the right to use the declared service).
access provider	Telecommunications companies that provide access to a declared service.
ADSL	Asymmetric Digital Subscriber Line. A technology for transmitting digital information at high data rates on existing copper phone lines. It is called asymmetric because the download and upload speeds are not symmetrical (that is, download is faster than upload).
AGVC	Aggregating Virtual Circuits (AGVC) are used to provide connectivity between one or more ADSL end-users and a centrally-located point of interconnect between the Telstra DSL network and an ISP network. AGVCs are used in conjunction with ATM protocol DSLAMS. Customers on newer Ethernet protocol DSLAMS require an Ethernet AGVC equivalent – a Virtual Local Area Network (VLAN).
avoidable cost	For a multi-product or multi-service firm, the avoidable cost of any service or combination of services is the long run cost avoided if a firm were to no longer offer that service or combination of services.
Building Block Model Record Keeping Rule	The Building Block Model Record Keeping Rule (BBM RKR) requests information on forecast and actual data from Telstra relating to operating expenditure, capital expenditure, depreciation and demand that is required to effectively implement the Fixed Line Services Model (FLSM). The FLSM is used as part of the ACCC's building block model-approach to determine prices for the declared fixed line services and wholesale ADSL.
capital expenditure	Capital expenditure refers to the amount spent by Telstra to acquire or upgrade any asset or part of an asset included in the FLSM Asset Classes. Capital expenditure forecasts are an input into calculating prices for the declared fixed line services. Forecast annual capital expenditure is rolled into the RAB each year and forms a component of the revenue requirement through the return on and of capital.
cost allocation factors	Each service's share of the aggregate revenue requirement is calculated by applying cost allocation factors to the total operating, capital and tax costs associated with each of the asset classes in the FLSM. The cost allocation factors represent the share of costs incurred in supplying a particular service.
Customer Access Network	Customer Access Network (CAN) is the portion of Telstra's fixed network of copper wires that connects each telephone end-user to the network switch at their local exchange. The CAN is used to supply customers with

	a range of fixed line services, including the declared fixed line services.
Comparison Statement	The Comparison Statement refers to the document Telstra submitted under the BBM RKR that compares forecasts of the previous regulatory period with actual figures for that period.
Core network	Telstra's Core network is used to transmit calls and data between major exchanges in the capital cities using the transmission network.
declaration inquiry	The process by which the ACCC holds a public inquiry to determine whether a service should be declared.
declared service	A service that the ACCC regulates under Part XIC of the CCA. Once declared, a service provider must supply the service to other parties in accordance with the standard access obligations and the terms and conditions set in the final access determination.
Definitive Agreements	Agreements made between Telstra and NBN Co on 23 June 2011 to migrate customers from Telstra's fixed line network to the NBN and for NBN Co to lease and acquire certain infrastructure from Telstra.
DSLAM	Digital Subscriber Line Access Multiplexer. A device which makes use of the copper access lines to provide high data rate services, enabling broadband services to be provided over copper lines. It is located in a telephone exchange that links many customer DSL connections (copper wires) to a core IP network via a backhaul system.
DTCS	Domestic Transmission Capacity Service. The regulated transmission service.
end-user	Retail residential and business consumers of telecommunication services.
exchange	Place where various numbers and types of communication lines are switched so as to establish a connection between two telephones. The exchange also houses DSLAMs, allowing end-users to connect to the internet.
Explanatory Statement	The Explanatory Statement refers to the document Telstra submitted under the BBM RKR that describes the methodology for the forecast estimates, assumptions used, cost drivers and any other observations from Telstra.
FAD	Final Access Determination. The FAD is made by the ACCC and sets the terms and conditions (including prices) on which a service provider must supply a declared service.
FOAS	Fixed Originating Access Service. The declared service replacing the previously declared PSTN OA service. Enables a telephone call to be connected from the caller to a point of interconnection with another network.
FTAS	Fixed Terminating Access Service. The declared service replacing the previously declared PSTN TA service. Enables a telephone call to be

	carried from the point of interconnection to the party being called on another network.
fixed line services	Telecommunications services provided over fixed networks, such as Telstra's copper network and HFC networks. The 'declared fixed line services' comprise seven services: the six fixed line services declared in 2014—the ULLS, LSS, WLR, LCS, FOAS and FTAS and the wholesale ADSL service declared in 2012.
fixed principles provision	An FAD may contain a fixed principles provision, which allows a provision in an FAD to have an expiry date after the expiry date of the FAD. Such a provision would allow the ACCC to 'lock-in' a term so that it would be consistent across multiple FADs.
FLSM	The Fixed Line Services Model (FLSM) is used as part of the ACCC's building block model-approach to determine prices for the declared fixed line services and wholesale ADSL.
IMC	The investment management committee is referred in Telstra's submissions to the BBM RKR in relation to Telstra's expenditures on various projects.
LCS	The declared Local Carriage Service. Enables access seekers to resell local calls to end-users without having to invest in their own network and switching equipment. The LCS is purchased in conjunction with the WLR service.
LSS	The declared Line Sharing Service. Enables access seekers to share the use of the copper line connecting consumers to the telephone exchange, allowing them to provide fixed internet services using their own equipment.
Main Distribution Frame	The main distribution frame (MDF) is a set of terminal points providing a means of interconnection between pairs. An MDF is used in many multi-dwelling residential and large commercial premises as a means of interconnection between Telstra's copper wire customer access network and the internal telephone wiring of the premises. There is also an MDF at the local telephone exchange which provides a point of interconnection between the main feeder network cables and the equipment inside the exchange.
MTAS	The declared Mobile Terminating Access Service. A wholesale service provided by a mobile network operator (MNO) to fixed line operators and other MNOs to connect – or 'terminate' – a call on its mobile network. It enables calls to be made to consumers on mobile phone networks.
operating expenditure	Operating expenditure refers to all ongoing direct and indirect operating expenditure relating to Fixed Line Services and the Wholesale ADSL service provided by Telstra. Forecast operating expenditure forms a cost block in the building block approach and therefore contributes directly to Telstra's total revenue requirement.

<i>propex</i>	Project-based operating expenditure (propex) is a term Telstra uses to distinguish operating expenditure associated with capital outlay from other direct and indirect operating expenditure types.
<i>PSTN</i>	Public Switched Telephone Network. The telephone network that allows the public to make and receive telephone calls via switching and transmission facilities and utilising analogue and digital technologies.
<i>PSTN OA</i>	The declared PSTN Originating Access service. The name of this service has been changed to Fixed Originating Access Service (FOAS). PSTN OA is still used to remain consistent with Telstra documentation where applicable.
<i>PSTN TA</i>	The declared PSTN terminating access service. The name of this service has been changed to Fixed Terminating Access Service (FTAS). PSTN TA is still used to remain consistent with Telstra documentation where applicable.
<i>retail service provider</i>	Companies that offer telecommunications services to end-users.
<i>revenue requirement</i>	The revenue requirement refers to the aggregate revenue requirement calculated by the FLSM that allows Telstra to recover its cost of supplying regulated services.
<i>special access undertaking</i>	A document given by the access provider proposing the terms and conditions on which it will offer access to its services (if approved by the ACCC, access seekers can obtain supply on these terms).
<i>Stand alone cost</i>	For a multi-product or multi-service firm, the stand alone cost of any service or combination of services of a firm is the cost of providing that service or combination of services in isolation.
<i>TEBA</i>	This commonly refers to space designated for access seeker use in Telstra's exchanges. It encompasses access to floor space, equipment racks or rack space and services such as power, security and air-conditioning. TEBA also includes access to cable trays and the internal interconnection cables contained in them.
<i>transmission</i>	The carriage of voice, data or other communications.
<i>ULLS</i>	The declared Unconditioned Local Loop Service. Allows access seekers to use the copper line connecting end-users to the local telephone exchange, allowing them provide both fixed internet (broadband) and voice services using their own DSLAMs and other exchange equipment.
<i>VLAN</i>	Virtual Local Area Networks are used to provide connectivity between one or more ADSL end-users and a centrally-located point of interconnect between the Telstra DSL network and an ISP point of presence. VLANs are used in conjunction with Ethernet based DSLAMs.
<i>wholesale ADSL</i>	The declared Wholesale ADSL service. Allows access seekers to

	purchase a Wholesale ADSL product from Telstra and resell internet services to end-users.
WLR	The declared Wholesale Line Rental service. For a monthly 'per-user' charge, it allows access seekers to purchase a line rental service from Telstra, which includes access to the copper line and associated services (including a dial tone and telephone number) supplied using Telstra's equipment.

Executive Summary

The ACCC is releasing this further draft decision to address issues outstanding from its March 2015 draft decision on primary price terms (March draft decision). The March draft decision and this further draft decision taken together constitute the ACCC's draft decision on the primary price terms to be included in the final access determinations (FADs) for the seven declared fixed line services supplied by Telstra on its copper PSTN and DSL networks.¹ The seven declared fixed line services are the:

- unconditioned local loop service (ULLS)
- line sharing service (LSS)
- wholesale line rental service (WLR)
- local carriage service (LCS)
- fixed originating access service (FOAS)
- fixed terminating access service (FTAS)
- wholesale ADSL

Issues on which the ACCC provided its draft decision in March are not considered further in this report and submissions received from stakeholders on those issues will be addressed in the final decision. The outstanding issues to which this further draft decision relates are:

- 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 (discussed under NBN impacts below).
- whether methods, assumptions and inputs proposed by Telstra for its cost allocation framework (CAF) are appropriate.

The ACCC's further draft decision is for a one-off 9.6 per cent decrease in the primary prices of the declared fixed line services, for the four-year period commencing on 1 October 2015 and finishing on 30 June 2019, as set out in the table below. This decision is based on information received from Telstra up to 2 June 2015.

A number of factors have contributed to the change in the estimated price movement between the March draft decision and this further draft decision. The most significant factors are: the draft decision to make adjustments to ensure that access seekers do not incur higher charges as a result of the loss of economies of scale due to the NBN; revisions to Telstra's forecast operating expenditure; and updates to reflect changes to the CPI forecast and the risk free rate used in the estimation of the weighted average cost of capital (WACC) in light of most recent information. In addition, a number of minor amendments have been made to the modelling.

¹ The ACCC made its declaration decision on the ULLS, LSS, WLR, LCS, FOAS, and FTAS services on 17 April 2014. The ACCC declared the wholesale ADSL service in February 2012

Table 1.1 Current and proposed charges for regulated fixed line services

Service	Unit	Current charges	Further draft decision
ULLS Bands 1 to 3	\$ per line per month	16.21	14.65
ULLS Band 4	\$ per line per month	48.19	43.56
WLR	\$ per line per month	22.84	20.65
LSS	\$ per line per month	1.80	1.63
LCS	¢ per call	8.90	8.05
FOAS & FTAS	¢ per minute	0.95	0.86
Wholesale ADSL Zone 1	\$ per port per month	24.44	22.09
Wholesale ADSL Zone 2/3	\$ per port per month	29.66	26.81
Wholesale AGVC/VLAN	\$ per Mbps per month	32.31	29.21

March draft decision

At the time of the March draft decision the ACCC did not have sufficient information to enable it to form a view as to the overall prudence and efficiency of operating expenditure and capital expenditure forecasts. In addition, the ACCC was yet to consider information and forecast revisions submitted by Telstra between January 2015 and the release of the draft decision. Consequently, the ACCC was able to form only a limited view as to the prudence and efficiency of Telstra's expenditure proposals. The ACCC stated it would update its draft decision on the prudence and efficiency of operating and capital expenditures when it had received the information it required. Telstra has now provided information requested by the ACCC and has also provided more explanation of its forecasts in its submission to the March draft decision.

In its March draft decision the ACCC stated that it intended to adopt a fully allocated cost framework to determine charges for the regulated services. The ACCC also stated that the CAF proposed by Telstra was likely to be an appropriate basis for establishing a fully allocated cost approach for the fixed line services model (FLSM) used to determine regulated charges. However, the ACCC was not able to reach a draft decision until it had assessed more fully the methodology used in the CAF to allocate costs to FLSM asset classes and to verify the inputs to the CAF.

In dealing with the issue of NBN impacts on fixed line assets, the March draft decision set out the ACCC's position on certain assets utilised to a lesser extent and made redundant by the migration of services to the NBN in addition to assets to be sold or leased to NBN. The ACCC also noted the impact of loss of economies of scale on unit costs due to NBN migration. The ACCC considered that the loss of economies of scale and density is incremental to the NBN and noted that it was still considering its approach on this issue.

The March draft decision estimated prices would fall by a uniform 0.7 per cent. This was an interim figure, subject to revision when the ACCC had obtained further information and addressed these outstanding issues.

The ACCC's draft decisions on these issues outstanding from March are as follows:

Operating Expenditure

In reaching this further draft decision the ACCC has considered the responses and revised forecasts Telstra's provided in February 2015 in conjunction with the further explanation of its operating expenditure provided in March 2015 and its submission to the ACCC draft decision.

The ACCC acknowledges Telstra's provision of requested further information and its substantial response to the draft decision on operating expenditure. This includes a detailed review of its costs allocations to the FLSM by KPMG and an upward revision of expenditure allocated to the FLSM as a result of this review and other evidence to suggest that it had been conservative in its expenditure allocation methodologies.

The further information Telstra has provided responds to the major concerns of the ACCC in the March draft decision regarding visibility of the basis on which costs were allocated by Telstra to the fixed line services.

While acknowledging continuing information limitations and asymmetries, the ACCC considers that the further information provided by Telstra has gone sufficiently towards addressing ACCC concerns it held at the time of the March draft decision regarding the transparency of the operating expenditure forecasts. Therefore, on the basis of this further information provided, Telstra's overall incentive to operate efficiently and subject to Telstra providing some additional clarifications, the ACCC has reached a draft decision to accept as prudent and efficient Telstra's revised May 2015:

- base year operating expenditure;
- forecast operating expenditure;
- non-NBN specific propex;
- forecast fault rate operating expenditure; and
- the capex-opex trade-off.

However, the ACCC maintains its draft decision that propex associated with NBN-specific capital expenditure is not caused by fixed line services and remains excluded from allowed operating expenditure.

The ACCC's reasons for its draft decision on operating expenditure are detailed in chapter 2.

Capital Expenditure

Telstra has responded to the ACCC draft decision with further explanation of its forecast methodology, including evidence to support its position that the forecasts are conservative. Telstra has provided revised capital expenditure forecasts that correct an error in the methodology used to estimate NBN-specific capital expenditure, and also cap the rate of growth of demand related capital expenditure.

As in the case of operating expenditure, the ACCC continues to have some reservations regarding the transparency of Telstra's forecasts. However, similarly, the ACCC considers that the further information Telstra has provided goes considerably towards addressing the concerns expressed in the March draft decision.

The ACCC considered that the suggestion by Frontier Economics and Optus for the ACCC to develop its own forecasts provides a useful cross-check of the reliability of Telstra's forecast capital expenditure. Following this assessment the ACCC finds that Telstra's forecast methodology appears to produce reasonable forecasts for the following reasons:

- once NBN-specific capital expenditure is removed, Telstra's capital expenditure forecast is: (i) below the ACCC's alternative forecasts pre-NBN rollout adjustment; and (ii) within the range of the ACCC's alternative forecasts after the NBN rollout adjustment.
- Telstra has made certain methodological assumptions to improve the reasonableness of its capital expenditure forecasts.

Therefore, on the basis of the information before it, the ACCC has reached a draft decision to accept as prudent and efficient Telstra's proposed total May 2015 forecast capital expenditure for the 2014–15 to 2018–19 period, subject to exclusion of NBN-specific capital expenditures. The ACCC maintains its view that expenditure that is incremental to the NBN rollout should not be recovered from users of the fixed line network. The ACCC considers that this treatment is consistent with the fixed principles provisions.

The ACCC's reasons for its draft decision on capital expenditure are detailed in chapter 3.

NBN impacts and loss of economies of scale

In its March draft decision the ACCC set out how it intended to treat certain assets made redundant as a consequence of the migration of services from Telstra's copper based network to the NBN and other assets that would, prior to eventual redundancy, be under-utilised during the transition to the NBN. The ACCC also noted the impact on operating costs of the loss of economies of scale as services are disconnected from Telstra's network and that it was still considering this issue. The ACCC has now reached a draft decision on this issue.

The ACCC considers that users of the fixed line network should not bear the costs associated with the loss of economies of scale that will occur as a result of NBN migration. The ACCC considers that these costs are caused by the migration of services to the NBN and that they are not caused by users of the fixed line services. Further, the ACCC considers 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.

In order to ensure that the costs associated with NBN-induced loss of scale economies are not reflected in regulated revenues, the ACCC's 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.
- 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 due to disconnection of services for migration to the NBN are not reflected in regulated charges.

The ACCC's reasons for its draft decision on NBN impacts and further details on the implementation of this draft decision are in chapter 4.

Cost Allocation

The ACCC maintains the position in the March draft decision that a fully allocated approach is appropriate for allocating the costs of Telstra's fixed line network. The ACCC is of the view that a fully allocated approach is: compatible with the building block methodology; likely to result in prices that reflect the relative cost of supplying the declared fixed line services; and forms an appropriate basis for accounting for the impacts of the NBN.

Analysys Mason has undertaken a review of the methodology and assumptions Telstra used to develop its CAF and a verification of the inputs used to determine the cost allocations for each of the FLSM asset classes. The ACCC is releasing a public version of the Analysys Mason report with this further draft decision.

The ACCC has considered the findings of the Analysys Mason report in forming its further draft decision on cost allocation. The ACCC considers that Telstra's proposed cost allocation framework, for the most part, is: based on accurate and verifiable information; based on reasonable assumptions and calculation methods; and reasonably reflects how fixed line assets are used by various services.

For twelve of the FLSM asset classes Analysys Mason recommended changes to the CAF to provide a more reasonable basis for allocation or to better reflect how fixed line assets are used. The ACCC proposes to adopt the Analysys Mason recommendations in nine of these cases.

However, Telstra's CAF does not deal with emerging excess capacity and has the effect of passing on costs associated with loss of economies of scale to users of fixed line services. As noted above, the ACCC considers that costs attributable to the NBN should not be borne by users of fixed line services. For assets that exhibit increasing unit costs due to the NBN, adjustments will be made to the cost allocation factors to keep unit costs of the declared services at the level that would occur absent the NBN.

Therefore, the ACCC draft decision on cost allocation is to adopt Telstra's CAF (as amended) subject to:

- certain minor adjustments identified during the assessment of the methodology and verification of input inputs Telstra used to develop the CAF.
- adjustment to allocation factors to give effect to the decision regarding the removal of cost impacts of loss of economies of scale due to the NBN.

The ACCC's reasons for its draft decision on the cost allocation framework are detailed in chapter 5.

Consultation on the further draft decision and next steps

The ACCC is seeking submissions on this further draft decision by **17 July 2015**.

The ACCC intends to release its final decision in September 2015.

1 Introduction

The Australian Competition and Consumer Commission (ACCC) is conducting a public inquiry under Part 25 of the *Telecommunications Act 1997* into making final access determinations (FADs) under section 152BC of the *Competition and Consumer Act 2010* (CCA) for the seven declared fixed line services (FAD inquiry). The seven declared fixed line services are the:

- unconditioned local loop service (ULLS)
- line sharing service (LSS)
- wholesale line rental service (WLR)
- local carriage service (LCS)
- fixed originating access service (FOAS)
- fixed terminating access service (FTAS)
- wholesale ADSL.

A description of the declared fixed line services is at appendix D to this draft decision.

In March 2015, the ACCC published its draft decision (the draft decision) for a one off 0.7 per cent decrease in the primary prices for the declared fixed line services. At the time of the draft decision, the ACCC was of the opinion that it did not have the information required to form a view on certain aspects of the inquiry.

This report sets out the ACCC's draft decision on the FAD terms for these outstanding issues (the "further draft decision") and its reasons for its decision. The outstanding issues that the further draft decision covers are:

- the prudence and efficiency of operating expenditure and capital expenditure
- the allocators within the fully allocated cost model
- the approach on higher unit costs resulting from loss of economies of scale as services are disconnected from the network as the NBN rollout proceeds.

In reaching its draft decision on these outstanding issues, the ACCC has considered submissions made on the March 2015 draft decision and information provided by Telstra on its expenditure forecasts since January 2015 (the cut-off for the ACCC's March draft decision). The ACCC has also considered submissions to the July 2014 discussion paper on primary price terms for the fixed line services and submissions to the October 2014 position statement on the Telstra-NBN Co arrangements. The legislative framework for the FADs is at appendix A to the report.

The draft decision, discussion paper, position statement and public submissions received are published on the ACCC web site.

The ACCC intends to publish its final decision on the FAD terms for the declared fixed line services in September 2015.

1.1 Background

The ACCC made FADs for six declared fixed line services in July 2011 and made a FAD for wholesale ADSL service in May 2013. All seven FADs will expire the day before the new FADs are made. In July 2013 the ACCC issued Telstra with a request for information under the Building Block Model Record Keeping Rule (BBM RKR). A number of factors meant that the

ACCC has not been able to complete the FAD inquiry before the original expiry date of the previous FADs:

- Statutory time requirements for the provision of, and subsequent disclosure arrangements, relating to Telstra's response to the BBM RKR.
- Changes to the NBN architecture mean that there has been a significant change in Telstra's operating environment. This necessitated a revision to Telstra's response to the BBM RKR and caused delays in the ACCC having available to it the information on demand and costs for Telstra's fixed line network it required for it to make its decision on the primary price terms for the FADs.
- The need to provide adequate opportunity for consultation with stakeholders on a range of complex pricing issues the ACCC is considering during its inquiry. These pricing issues include the approach on the Telstra-NBN Co arrangements and cost allocation and declining demand in addition to assessment of the demand and expenditure forecasts Telstra has submitted.

The ACCC has extended the initial six month inquiry period for making the FADs to 11 July 2015 and the expiry date of the current FADs in consequence of these circumstances. The ACCC intends to further extend the inquiry period beyond 11 July 2015.

The ACCC published, under section 152BCK(3) of the CCA, notices of extension to the decision making period on 11 December 2013, 3 July 2014 and 12 December 2014. On 18 June 2014 the ACCC extended, under section 152BCF(10) of the CCA, the expiry date of the 2011 and 2013 FADs to be the day immediately before the day on which the access determination for the next regulatory period come into force.

On 18 June 2014, the ACCC also varied the fixed line services FADs following a variation inquiry that commenced on 17 April 2014. The variations to the FADs specified price and non-price terms for the supply of the LCS and WLR service in CBD areas and specified a regulated price for the internal interconnection cable (IIC) service, a supplementary service required for the supply of the ULLS and LSS.

1.2 Public inquiry process to date

On 11 June 2014, the ACCC gave a disclosure notice to Telstra for the disclosure of information that has been provided under the BBM RKR. The ACCC also published a statement of reasons to accompany the notice.

On 24 July 2014, the ACCC published its primary price terms discussion paper for the FAD inquiry. The ACCC also published a supplementary report providing additional information on Telstra's cost allocation proposal which compared Telstra's proposed cost allocation approach to the approach taken in the previous fixed line FADs.

The ACCC conducted a technical workshop on 28 August 2014 which provided access seekers the opportunity to seek further information regarding the FLSM, Telstra's cost allocation proposal and its BBM RKR response.

On 22 October 2014, the ACCC released its position statement on how it intends to account for the arrangements between Telstra and NBN Co in determining primary prices in the FAD inquiry, in advance of a more comprehensive draft decision. The Telstra-NBN Co arrangements are set out in the Definitive Agreements concluded in June 2011 and renegotiated in December 2014. Matters covered in the Definitive Agreements include the migration of customers to the NBN and NBN acquisition and use of Telstra's infrastructure.

The ACCC engaged WIK-Consultant to report on the prudence and efficiency of Telstra's operating expenditure and capital expenditure forecasts submitted on 3 October 2014. A public version of the consultant's report was published on the ACCC web site with the draft decision.

On 11 March 2015, the ACCC released its draft decision on the primary price terms for the declared fixed line services. Along with the ACCC's draft decision on the uniform price decrease of 0.7 per cent, the ACCC set out its draft decision on the supplementary price terms for IIC charges and the scope of the application of the SAOs.

Stakeholders have submitted on the draft decision since its publication. Submissions were due on 30 April 2015. However, stakeholders have had the opportunity to continue to engage with the ACCC on concerns with aspects of the draft decision.

After the release of the draft decision report, the ACCC engaged Analysys Mason to undertake further assessment and verification of Telstra's proposed cost allocation model. A public version of the consultant's report will be published on the ACCC web site with this further draft decision.

1.3 Consultation process

The ACCC encourages industry participants and other interested parties to make submissions on this further draft decision.

All submissions will be considered as public submissions and will be posted on the ACCC's website. Interested parties wishing to submit commercial-in-confidence material to the ACCC should submit both a public and a commercial-in-confidence version of their submission. The public version of the submission should clearly identify the commercial-in-confidence material by bookending the confidential material with an appropriate symbol or 'c-i-c'.

The ACCC expects that claims for commercial-in-confidence status of information by parties will be limited in order to promote transparency and broad participation in the public inquiry.

The ACCC-AER information policy: the collection, use and disclosure of information sets out the general policy of the ACCC and the Australian Energy Regulator on the collection, use and disclosure of information. A copy of the guideline can be downloaded from the ACCC's website.

The ACCC prefers to receive submissions in electronic form, either in PDF or Microsoft Word format which allows the submission text to be searched. Please contact Jane Goldwater regarding any questions you have concerning the consultation process on (03) 9290 1493.

Submissions on this further draft decision are due by **5:00 pm on 17 July 2015**.

When it has considered the submissions received on the further draft decision, the ACCC will decide whether further consultation is required before it makes its final decision. The ACCC intends that, if further consultation is warranted, it will be targeted on specific issues and will not delay release of the ACCC's decision in September 2015.

1.4 Structure of report

This report sets out the draft decision on outstanding issues to the draft decision report. This report is set out as follows:

Chapters 2 to 5 the ACCC's draft decision on the previously mentioned outstanding issues to the draft decision report published in March 2015

Appendix A sets out the relevant legislative framework for making FADs

Appendix B lists the submissions received by the ACCC to date to this inquiry on primary price terms.

Appendix C sets out the fixed principles provision in the FADs.

Appendix D sets out the service descriptions of the declared fixed line services.

2 Operating expenditure forecasts

Key Points

- The ACCC draft decision raised concerns that Telstra had presented insufficient evidence in support of the relevance, efficiency and prudence of its proposed operating expenditures. As a result, the ACCC could not form a view on the prudence and efficiency of the following Telstra operating expenditures:
 - 2013-14 base year operating expenditures
 - forecast operating expenditures
 - propex
 - the forecast change in the fault rate
 - the capex-opex trade-off.
- In its draft decision, the ACCC considered that in the absence of further information from Telstra that demonstrates an improvement in the transparency of the above operating expenditures, the ACCC may make adjustments to these expenditures. The ACCC has now considered submissions from Telstra and stakeholders in which to make a further draft decision on these proposed operating expenditures.
- In February 2015, Telstra submitted further information and operating expenditure adjustments. The ACCC raised with Telstra its concerns in relation to the numerous revisions and upward adjustments to its forecast operating expenditures without there being sufficient supporting evidence to explain or justify them. The ACCC draft decision did not consider the February information as the ACCC had concerns about the prudence and efficiency of the proposed adjustments and the ACCC had insufficient time to scrutinise Telstra's responses.
- In these responses, Telstra made further revisions to its proposed operating expenditures.
- For its submission to the draft decision, Telstra engaged KPMG to review the allocation of its general ledger operating expenditures to FLSM asset classes. Telstra accepted KPMG's review recommendations which (largely) resulted in Telstra's May 2015 proposed forecast operating expenditures increasing by over [c-i-c starts] [c-i-c ends] million in real terms compared to its January 2015 forecasts. In conjunction with these changes, Telstra has provided further information, evidence and explanation of its proposed operating expenditures.
- In this further draft decision, Telstra's February 2015 responses are considered in conjunction with Telstra's further explanation of its operating expenditure in March 2015 and Telstra's responses to the ACCC draft decision.
- The ACCC's further draft decision is that on the basis of the further information and explanation that Telstra has provided to date and subject to some additional clarification of some specific expenditure items, it accepts as prudent and efficient Telstra's base year operating expenditure, forecast operating expenditure, propex, the forecast fault rate and Telstra's consideration of the capex-opex trade-off.
- The ACCC's further draft decision also reverses the ACCC's draft decision to remove Telstra's upward adjustment to its business unit support mark-up percentage. Telstra has provided sufficient information and explanation for this adjustment. This has resulted in approximately \$[c-i-c starts] [c-i-c ends] million of real additional allowed operating expenditure over the forecast period based on Telstra's forecast expenditure.
- NBN-specific propex remains excluded from Telstra's forecast operating expenditures. However, the amount excluded has fallen from \$[c-i-c starts] [c-i-c ends] million to \$[c-i-c starts] [c-i-c ends] million in real terms since Telstra has reduced the proposed amount of NBN-related capital expenditure in its most recent forecasts.

2.1 Introduction

This chapter examines the submissions of Telstra and other stakeholders in response to the ACCC March 2015 draft decision (draft decision)² and details how the ACCC's further draft decision is formed. It includes consideration of Telstra's responses and revisions that were submitted just prior to and after the draft decision. Section 2.2 summarises the operating expenditure issues identified in the draft decision that are relevant for the further draft decision. These are Telstra's proposed base year operating expenditure, its operating expenditure forecasts, propex, the forecast fault rate and the capex-opex trade-off. Section 2.3 details the ACCC's further draft decision in relation to each of these issues. The section includes summaries of additional material provided by Telstra since the draft decision and submissions from Telstra and other stakeholders in response to the draft decision on the relevant issues.

2.2 March 2015 draft decision

The ACCC's draft decision on Telstra's forecast operating expenditure was based on information provided and submissions made by Telstra up to January 2015. In the draft decision, the ACCC outlined a number of issues with Telstra's proposed base year and forecasts of its operating expenditures. These issues that are addressed in the further draft decision are highlighted below.

Base year operating expenditure

For Telstra's base year operating expenditure, the ACCC was concerned that Telstra did not provide sufficiently transparent and verifiable cost allocation information that would permit scrutiny of the traceability of costs from the general ledger to asset classes in the FLSM and whether costs incurred in Telstra's fixed line cost centres are relevant to the provision of fixed line services.

As a result, the ACCC could not form a view on whether or not Telstra's base-year 2013–14 operating expenditures are prudently and efficiently incurred. In its draft decision the ACCC did not make any adjustments to Telstra's base year operating expenditure for reasons of prudence and efficiency. However, the ACCC noted that it would consider this issue again after receiving further information from Telstra and submissions from stakeholders.³

Forecast operating expenditure

In its assessment of Telstra's operating expenditure forecasts the ACCC considered that Telstra had not demonstrated a transparent and verifiable relationship between forecast demand and forecast operating expenditure that would permit sufficient scrutiny of how Telstra's costs respond to changes in fixed line service demand. As a result, the ACCC could not form a view on whether or not Telstra's forecast operating expenditures are prudently and efficiently incurred.

The ACCC's draft decision was to not make adjustments to Telstra's forecast operating expenditure for reasons of prudence and efficiency. The exception to this was the removal of Telstra's upward adjustment to its Business Unit Support mark-up, the removal of NBN-related propex and an adjustment to Telstra's forecast CPI.⁴ However, the ACCC noted that it would consider these issues again after receiving further information from Telstra and submissions from stakeholders.⁵

² ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015.

³ *ibid*, p. 34.

⁴ *ibid*, Chapter 8.

⁵ *ibid*, p. 46.

Propex

In the draft decision, the ACCC was concerned that there was considerable difficulty in identifying whether propex is caused by the relevant asset classes and, ultimately, whether propex is relevant to the provision of fixed line services. The ACCC's draft decision was that it could not form a view on the prudence and efficiency of Telstra's proposed propex since there was insufficient information and transparency on what is causing these costs to be incurred.

The ACCC's draft decision was to not make adjustments to Telstra's forecast propex. The exception to this was the removal of NBN-related propex. However, the ACCC noted that it would consider this issue again after receiving further information from Telstra and submissions from stakeholders.⁶

Forecast fault rate

In the draft decision, the ACCC had concerns about what is expected to cause the [c-i-c starts] [redacted] [c-i-c ends] increase in Telstra's forecast growth of fault rates for 2016–17 to 2018–19 as the information provided by Telstra had not sufficiently explained the causes. The forecast increase in the growth rate of fault rates [c-i-c starts] [redacted] [c-i-c ends] was also inconsistent with Telstra's dedicated program to reduce faults. The ACCC was also concerned that Telstra had not provided sufficient justification that NBN-induced faults are excluded from its forecast growth of fault rates.

In the draft decision, the ACCC accepted Telstra's forecast growth of the fault rate. However, in the absence of further information from Telstra that sufficiently explained that the forecast increase in the growth rate of fault rates from 2016–17 to 2018–19 is attributable to causes other than NBN, the ACCC considered that it would make adjustments to Telstra's fault rate projections prior to making its final decision.⁷

Capex-opex trade-off

In the draft decision the ACCC expressed concern that Telstra had not adjusted its forecast expenditures in recognition of the trade-off between capital expenditure and operating expenditure. The lack of recognition of this trade-off was considered likely to result in an over-estimate of Telstra's expenditure forecasts for the next regulatory period.

The ACCC's draft decision was to not make adjustments to Telstra's forecast operating expenditure on the basis of the trade-off between capital expenditure and operating expenditure. However, the ACCC stated that it would consider the issue again after receiving further information from Telstra and submissions from stakeholders.⁸

2.3 ACCC further draft decision

2.3.1 Overview

Under a BBM approach, forecast operating expenditure should reflect prudent and efficient costs. The fixed principles provisions specify that the following matters are relevant to whether Telstra's operating expenditure forecasts are prudent and efficient:

- the access provider's level of operating expenditure in the previous regulatory period
- the reasons for proposed changes to operating expenditure from one regulatory period to the next regulatory period
- any relevant regulatory obligations, or changes to such obligations, applicable to providing the relevant declared fixed line services

⁶ *ibid*, pp. 53-54.

⁷ *ibid*, p. 55.

⁸ *ibid*, p. 58.

- any other matters relevant to whether forecasting operating expenditures reflect prudent and efficient costs.⁹

In the draft decision the ACCC was concerned that Telstra's base year and proposed forecast operating expenditure may not have comprised prudent and efficient costs, having regard to the second and fourth criteria. More specifically, there was a concern that Telstra had not demonstrated 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.¹⁰

Consequently, for the following operating expenditures:

- base year operating expenditure
- forecast operating expenditure
- propex
- forecast fault rate operating expenditure
- the capex-opex trade-off,

the ACCC could not form a view on whether Telstra had incurred prudent and efficient operating expenditures for the fixed line services. The ACCC considered that Telstra had not sufficiently explained how it incurred or expected to incur these expenditures. The ACCC draft decision was that in the absence of further information from Telstra that justifies these expenditures, it may make adjustments to Telstra's forecast expenditures.

The ACCC accepts Telstra's proposition that, on the basis that the vast majority of Telstra's revenues are obtained from unregulated services in reasonably competitive markets, Telstra as a whole has an incentive to operate efficiently.¹¹

Telstra does nonetheless have an incentive to inflate costs allocated to the regulated FLS where it has the opportunity to do so in order to achieve higher prices where it does not face strong competition and disadvantage its competitors in downstream markets. The provision of information detailing the basis of Telstra's costs allocations can help to address questions of prudence and efficiency in respect to these regulated FLS costs. The deficiency of the information provided by Telstra on these allocations was the key reason why the ACCC could not reach a decision on the prudence and efficiency of these costs in the draft decision.

However, Telstra has provided considerable further information and explanation for its proposed base year and forecast operating expenditures in its February-March 2015 responses and in its submissions to the draft decision. The information and explanations contain detailed evidence on the causes of Telstra's operating expenditures (including upward revisions it has made to them since the draft decision) and on the cost and technical constraints Telstra encounters in reducing its operating expenditure in response to the SIO migration to NBN. This included substantial evidence that Telstra had been conservative in estimating the levels of base year and forecast operating expenditure allocated to the FLS.

On the basis of this additional information, the ACCC's further draft decision is to accept Telstra's base year and forecast operating expenditures as prudent and efficient (with the exception of NBN-related propex). This decision is subject to Telstra providing further information in relation to activity-based management (ABM) code information to support its

⁹ The ACCC's fixed principles provisions are provided in Appendix C. See clause 6.9.

¹⁰ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, p. 29.

¹¹ Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, Confidential Version, p. 83.

approach for allocating indirect costs associated with Customer Service Delivery (CSD) 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 These will be considered further prior to the final decision.

The ACCC has also decided to reverse its draft decision to remove Telstra’s proposed adjustment to its business unit support mark-up. Telstra has provided sufficient information and explanation that justifies its proposed adjustment to this mark-up.¹² This amount corresponds to an increase in the business unit support mark-up from [c-i-c starts] [c-i-c ends] per cent to [c-i-c starts] [c-i-c ends] per cent or approximately [c-i-c starts] [c-i-c ends] in real terms over the forecast period.¹³ The ACCC’s further draft decision is to accept Telstra’s revised operating expenditure forecasts with the exception of forecast NBN-related propex which remains excluded from Telstra’s forecast operating expenditure (a reduction of [c-i-c starts] [c-i-c ends] million in real terms for the years 2014–15 to 2018–19). In its proposed forecast of operating expenditures, Telstra has accepted the ACCC’s adjustment to its forecast change in the CPI. The impact of the proposed further draft decision changes on Telstra’s real forecast operating expenditures are summarised in Table 2.1 below.

It is to be noted that the further draft decision only relates to ACCC draft decisions where views on the prudence and efficiency of operating expenditures could not be formed in March. Hence it does not include consideration of NBN-related propex, forecast CPI and Telstra’s choice and application of cost and productivity indices. However, the quantum of the NBN-related propex adjustment has changed in response to Telstra’s change in the forecast amount of NBN capital expenditure since the draft decision.

Table 2.1 Telstra’s proposed forecast operating expenditures and the ACCC’s draft and further draft decision (2009 dollars) [c-i-c starts]

	2014–15	2015–16	2016–17	2017–18	2018–19
Telstra Proposed Fixed Line Opex (January 2015)	[c-i-c starts] [c-i-c ends]				
ACCC Draft Decision*	[c-i-c starts] [c-i-c ends]				
Telstra Proposed Fixed Line Opex (May 2015)	[c-i-c starts] [c-i-c ends]				
ACCC Further Draft Decision**	[c-i-c starts] [c-i-c ends]				

[c-i-c ends]

* The adjustment includes the ACCC’s draft decision that the annual forecast change of the CPI should be [c-i-c starts] [c-i-c ends] per cent for the financial years 2014–15 to 2018–19.

** The Further Draft Decision allows Telstra’s adjustment to its Operations business unit support mark-up including other major adjustments Telstra has proposed to the attribution of its expenditures from the general ledger to FLSM asset classes in its May submissions. NBN-propex is still excluded however, as discussed above. Note the adjustments are subject to rounding error.

¹² Telstra, Calculating the FLSM share of Operations Business Unit Support – Deriving a Mark-up ratio, 23 February 2015, pp. 1-2; Telstra (2015), *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, pp. 96-99.

¹³ Telstra, Fixed Services Forecast Model, v1.2 (May 2015).

Source: Telstra (2015) Fixed Services Forecast Model v1.1 (Jan2015); Telstra (2015), Fixed Services Forecast Model v1.2 (May 2015).

The ACCC further draft decision with respect to each of the operating expenditure issues raised in the draft decision is set out in detail below. This includes consideration of the ACCC's draft decision assessment, Telstra's applicable February and March 2015 responses to ACCC information requests, relevant WIK-Consult advice to the ACCC and Telstra's response to the WIK-Consult advice and Telstra and other stakeholders' submissions to the ACCC draft decision.

Where base year and forecast expenditure amounts are designated as being in 'real terms', this means real 2009 dollars (i.e. deflated to 2009 dollars using CPI).

2.3.2 Efficiency and prudence of Telstra's 2013–14 base year operating expenditure

2.3.2.1 ACCC draft decision

The ACCC's draft decision on Telstra's rebased operating expenditure was based on information provided and submissions made by Telstra in January 2015. The ACCC's draft decision was that Telstra had not provided sufficiently transparent and verifiable cost allocation information that would permit scrutiny of the traceability of costs from asset class to general ledger; and whether costs incurred in Telstra's fixed line cost centres are relevant to the provision of fixed services.

The ACCC also shared WIK-Consult's concerns that because base year expenditures for Customer Service Delivery (CSD), Networks, Information Technology Solutions (ITS) and Telstra Service Operations (TSO) business units were hardcoded it was not possible to determine whether these expenditures were prudent and efficient. Similarly, because the allocations of ITS and TSO operating expenditure to asset classes were also hardcoded, it was not clear whether or not these allocations reflected the principle of cost causation.¹⁴

As a result, the ACCC could not form a view on whether or not Telstra's base-year 2013–14 operating expenditures were prudently and efficiently incurred.

2.3.2.2 6 February 2015 response

In its February 2015 response, Telstra provided further reconciliation of the base-year (2013–14) fixed line operating expenditure with its general ledger expenditures. Telstra also identified small discrepancies which required adjustments to the split of operating expenditure costs between ITS categories, the split of operating expenditure costs between TSO business groups and the ratios for management mark-up, logistics mark-up and training mark-up for both ITS and TSO.¹⁵

Telstra also made adjustments to its CSD cost centre in order to remove contractor costs for connection and disconnection of service activities. Given that connection and disconnection of fixed line services are costed and charged separately, Telstra reduced the CSD costs to avoid the risk of double counting these costs¹⁶. The total reduction in contractor costs for connection and disconnection activities from these adjustments is \$[c-i-c starts] [c-i-c ends] million in 2013–14 in real terms. This removal had also reduced the level of CSD costs for each forecast year.¹⁷

¹⁴ Wik-Consult (2015), *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, Bad Honnef, March 2015, p. 61.

¹⁵ Telstra, *Amendments to the Fixed Line Services Model*, 6 February 2015, p. 27.

¹⁶ *ibid.*, p. 7.

¹⁷ *ibid.*, p. 7.

2.3.2.3 23 February 2015 response: the business unit support mark-up adjustment

In its 19 January submission on the base year and forecast operating expenditures, Telstra elevated its business unit support mark-up from [c-i-c starts] [c-i-c ends] per cent to [c-i-c starts] [c-i-c ends] per cent.¹⁸

In its February submission Telstra provided further information on the adjustment to the business unit support mark-up in the earlier submission which indicated that the previous calculation of the mark-up percentage was based on the share of indirect business unit support expenditure to the total amount of Telstra Operation business unit expenditure, whereas it should have been calculated based on the share of indirect expenditure to direct expenditure.¹⁹ As a result of the correction, the Telstra Business Unit Support mark-up is [c-i-c starts] [c-i-c ends] per cent.²⁰

2.3.2.4 Telstra’s March 2015 response

In March 2015, Telstra provided a comprehensive explanation and mapping of its operating expenditures from general ledger to FLSM asset classes and undertook further adjustments to its base-year and forecast operating expenditures.²¹

Telstra submitted that in the course of mapping general ledger expenditures to asset class and reconciling expenditures, further adjustments to its FLSM base year operating expenditures were required. The March 2015 adjustments to its operating expenditures resulted in Telstra proposing FLSM version 1.2.

The overall operating expenditure for 2013–14 was [c-i-c starts] [c-i-c ends] per cent higher (from [c-i-c starts] [c-i-c ends] to [c-i-c starts] [c-i-c ends] in real terms) than the 2013–14 operating expenditure proposed in version 1.1 (February 2015) of the Telstra’s FLSM.²² Telstra documented the reasons for the increase in operating expenditure between version 1.1 and version 1.2.

The result of Telstra’s mapping of general ledger expenditures to asset classes for the purpose of its FLSM version 1.2 are identified in Table 2.2 below.

Table 2.2 Operating expenditure in the general ledger by cost centre and FLSM relevant operating expenditure [c-i-c starts]

Cost Centre-Line of Business	Total expenditure identified in general ledger	Expenditure attributable to FLSM asset class	Fixed line relevant operating expenditure as a percentage of total cost centre expenditure
CSD	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]
Networks	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]
ITS	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]

¹⁸ ‘Opex forecasts’, Telstra (2015) Fixed Services Forecast Model v1.1 (Jan2015)

¹⁹ Telstra, Calculating the FLSM share of Operations Business Unit Support – Deriving a Mark-up ratio, 23 February 2015.

²⁰ *ibid*, pp. 1-2; Telstra, *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, pp. 96-99.

²¹ Telstra, *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence.

²² *ibid*, p. 4.

	[REDACTED]		
TSO	[REDACTED]	[REDACTED]	[REDACTED]

[c-i-c ends] Source: Telstra (2015), *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, Telstra (2015) FLSM FY2015 to FY2019 v 1.2.

Telstra highlighted constraints and impediments in identifying and mapping of expenditures in the general ledger to the FLSM asset classes. Telstra’s response to the BBM RKR in November 2013 was the first time Telstra was required to estimate direct and indirect operating expenditure specifically related to the individual FLSM asset classes.²³

Telstra submitted that since Telstra’s accounting systems do not systematically record operating expenditure information or with sufficient granularity to enable an automated extraction of relevant operating expenditure, Telstra had to develop a novel, bottom-up assessment of operating expenditure incurred across a number of organisation units. Telstra noted that in some cases, secondary sources and assessment by subject matter experts within relevant parts of the business were required in order to identify relevant costs and to inform the allocation of costs to individual FLSM asset classes.²⁴

2.3.2.5 Telstra’s response to the draft decision

In its submission to the draft decision Telstra detailed reasons why it considered that Telstra operates efficiently and it would not be commercially sensible for Telstra to allocate inefficient levels of costs to the regulated fixed line services.²⁵

Telstra provided further information to support the allocations and efficiency of its base year operating expenditure and justified why it had undertaken further adjustments to this expenditure in light of a review of its base year operating expenditure by KPMG.²⁶

Networks expenditure

Telstra submitted its mapping of Networks operating expenditure to FLSM asset classes based on the judgements of subject matter experts and other secondary data sources is likely to be an under-estimate of actual FLSM operating expenditure. Telstra compared this approach to allocating Networks operating expenditure from the GL to FLSM asset classes with the use of activity-based management (ABM) codes. In doing so, Telstra demonstrated that if it were to employ the ABM approach instead it would have assigned an additional [c-i-c starts] [REDACTED] [c-i-c ends] to FLSM asset classes.²⁷

In response to the ACCC and WIK-Consult’s concerns that electricity consumption of network equipment may be an inappropriate cost driver of network building space, Telstra submitted that it appreciated that this proxy – which allocates [c-i-c starts] [REDACTED] [c-i-c ends] per cent of network building space to FLSM asset classes – is indirect and ‘second best’.²⁸ However, due to the absence of alternative information at the time of the 2013 BBM RKR, Telstra considered

²³ *ibid*, p. 3.

²⁴ *ibid*, p. 3.

²⁵ Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, Confidential Version, p. 83.

²⁶ *ibid*, p. 57.

²⁷ *ibid*, p. 18 and pp. 76-78.

²⁸ *ibid*, p. 79.

the Network Electricity Consumption Model (NECM) provided a reasonable basis for cost allocation and that such an approach was likely to be conservative.

Telstra provided the results of an analysis it had subsequently undertaken which suggested that the NECM proxy was reasonable when cross-checked against the shares of costs incurred by FLSM asset classes using:

- Contractor maintenance logs for Telstra's individual network sites
- Land tax paid by site
- Council/water rates by site.²⁹

Based on these data Telstra argued that the NECM results appear conservative and potentially understates FLSM-relevant accommodation costs by [c-i-c starts] [REDACTED] [c-i-c ends].³⁰

KPMG found that for the 2013–14 base year, Telstra's Network model (applied to the Networks cost centre) overstated network maintenance contract operating expenditure by approximately [c-i-c starts] [REDACTED] [c-i-c ends]. Telstra accepted KPMG's finding of error and adjusted its network maintenance contract operating expenditure. The result is that the forecasts for 2014–15 to 2018–19 are reduced annually by the overstated amount.³¹

The estimations of FLSM-relevant ITS and TSO expenditures

The KPMG review of Telstra's cost allocations identified some errors with Telstra's allocation methodology of ITS and TSO expenditure to FLSM asset classes. These were:

- An error in the manner in which IT systems and applications were identified for the purpose of determining FLSM operating expenditure. This has implications across ITS, TSO and the business support and corporate support mark ups. KPMG identified that this error led to an overall understatement of operating expenditure of [c-i-c starts] [REDACTED] [c-i-c ends].
- It was not considered appropriate to use two years' data to develop allocators for a single year's direct operating expenditure for ITS direct, TSO direct (NITO) and ITS and TSO indirect operating expenditure – which lead to a total overstatement of operating expenditure by [c-i-c starts] [REDACTED] [c-i-c ends].³²

Telstra accepted these findings and adjusted both its general ledger reconciliation document and the FLSM operating expenditure forecasts. Telstra provided general ledger information and other documentation that supported KPMG's findings and recommended adjustments.

Benchmarking of Telstra's base year operating expenditure

Telstra provided an expert report (from NERA) that benchmarked the efficiency of Telstra's operating expenditure for the base year (2013-14) (based on its 7 February 2014 cost data submitted to the ACCC) against the operating expenditure of British Telecom (BT) in the year ending 31 March 2014.

The comparison was made with BT on the basis that it is one of the few telecoms operators with the detailed accounts showing a breakdown of costs on a service-by-service basis and it had been found by other recent studies to be efficient.

The efficiency comparison was made for operating expenditure aggregated over the following Telstra FL wholesale services for which BT provides a similar service:

- WLR

²⁹ *ibid*, Appendix 4, p. 246.

³⁰ *ibid*, pp. 18, 79-80.

³¹ *ibid*, p. 70.

³² *ibid*, p. 57.

- ULLS (Bands 1-3)
- PSTN origination and termination
- WADSL

Aggregation of the costs for the different services was undertaken in order to control for potential differences in cost allocation across the different services.

To account for the difference in the size of BT's operations, BT's unit costs were multiplied by Telstra's service volumes. These costs were then compared with Telstra's costs (converted to pounds at a PPP exchange rate) for the same volumes.

The results indicate that Telstra's total operating expenditure across the four services is [c-i-c starts] [c-i-c ends] per cent higher than if it had BT's unit costs. However Given that Telstra faces lower population density and greater dispersion of its customer population than BT, Telstra is considered not to be inefficient in comparison to BT.³³

Telstra's consideration of further operating expenditure adjustments

Telstra submitted that its mapping of expenditures from the general ledger to FLSM asset classes is likely to be an underestimate since the activity codes Telstra employed to map Telstra Operations expenditures to asset class were also shared by the budget head expenditures Telstra Retail and Global Enterprise & Services Group. Telstra estimated that just over [c-i-c starts] [c-i-c ends] in costs related to the same activities of Telstra Operations were incurred by Telstra Retail and Global Enterprise & Services Group.³⁴ Telstra submitted that this study suggested that significant relevant expenditure may have been excluded from the FLSM.³⁵ However, Telstra decided not to include these operating expenditures because more thorough analysis was required.³⁶ Telstra also stated it did not have time to review other business units where even further FLSM relevant operating expenditure may be identified.³⁷

2.3.2.6 Other stakeholder responses to the draft decision

Frontier

Frontier Economics (Frontier) submitted that given the opacity of Telstra's cost derivation and allocation methodology, the ACCC should not accept that Telstra's base year operating expenditures are prudent and efficient. It considered that to do so would set an unhelpful precedent for the future by signalling that in the absence of good evidence the ACCC will simply accept regulated businesses' proposals, which opens opportunities for gaming.³⁸ Frontier proposed that the ACCC develop its own independent estimate of base year expenditures following the approach of the AER.³⁹

Frontier supported the proposal by WIK-Consult that expenditure should be allocated according to sub-categories of asset classes, namely regulated fixed line services, non-regulated fixed line services, NBN and other services.⁴⁰ It considered that a weakness of the FLSM is that it treats too much of the costs as shared costs that are allocated using usage-based allocations.

³³ *ibid*, Appendix 14.

³⁴ *ibid*, p. 75.

³⁵ *ibid*, p. 75.

³⁶ *ibid*, p. 220.

³⁷ *ibid*, p. 8.

³⁸ Frontier, *Submission on the ACCC's draft decision on fixed line prices, A Report Prepared For the Competitive Carriers Coalition, iiNet and Optus*, May 2015, p. 11.

³⁹ *ibid*, pp. 11-12.

⁴⁰ *ibid*, p. 19.

This was considered a particular problem for services, such as the fixed line services, that are undergoing a period of transition.⁴¹

Frontier submitted that there is sufficient doubt about Telstra's base year costs to support a price fall for the regulated fixed line services.⁴²

Further, Frontier held the view that Telstra is highly likely to have over-recovered costs for the regulated FLS for previous years including for 2014–15 due to the carry-over of the previous price terms, providing added justification for the ACCC to trim Telstra's operating expenditure estimates.⁴³

Optus

Optus submitted that it is appropriate that the ACCC be concerned about the lack of transparency and traceability (such as tracing costs from general ledger to asset classes) of Telstra's base year and forecast operating expenditure in determining whether this expenditure is prudent and efficient. It considered that if Telstra is unable to better satisfy the ACCC of the prudence and efficiency of this expenditure, the ACCC should not accept the expenditure as it has done in the draft decision, but adopt an alternative approach.⁴⁴

Optus questioned the lack of substantiation by Telstra in making several upward revisions to base year CSD maintenance expenditure.⁴⁵

iiNet

iiNet supported the recommendations of Frontier Economics in relation to the establishment of independent base year expenditures and forecasts (including the use of 'top down' approach to reflect the change in the number of SIOs with the roll out of the NBN) on the basis that it had little confidence that the levels and the allocations of cost to the declared services are prudent and efficient.⁴⁶

2.3.2.7 ACCC further draft decision assessment

The ACCC accepts Telstra's proposition that, on the basis that the vast majority of Telstra's revenues are obtained from unregulated services in reasonably competitive markets, Telstra as a whole has an incentive to operate efficiently.

However, contrary to Telstra's claims in its submission, the ACCC considers Telstra does have an incentive to inflate costs allocated to the regulated FLS where it has the opportunity to do so in order to achieve higher prices where it does not face strong competition and disadvantage its competitors in downstream markets. These factors mean that while Telstra may not inefficiently allocate costs to the regulated FLS in practice, it does nonetheless have an incentive to do so in the regulated price setting process.

The provision by Telstra of more detailed information on its cost allocations since the draft decision helps to address questions of prudence and efficiency in respect of costs allocations to the regulated FLS. The ACCC's assessment of this information is detailed below.

⁴¹ *ibid*, p. 20.

⁴² *ibid*, p. 20.

⁴³ *ibid*, p. 8.

⁴⁴ Optus, *Submission in response to ACCC Draft Decision, Public Inquiry into final access determinations for fixed line services – primary price terms*, Confidential Version, April 2015, pp. 56-57, 59.

⁴⁵ *ibid*, p. 74.

⁴⁶ iiNet, *Public inquiry into final access determinations for fixed line services – primary price terms*, Draft Decision, March 2015, Confidential Version, pp. 4-5.

Transparency of Telstra's cost allocations

Telstra's 6 February 2015 response provided the ACCC with more information about Telstra's costs allocations, but elicited further ACCC concerns about the prudence and efficiency of Telstra's proposed amendments to its operating expenditure.

In March 2015, Telstra submitted an extensive cost allocation mapping from its budget head expenditure accounts in the general ledger to the operating expenditures for each asset class in the FLSM. The ACCC is satisfied that Telstra has provided sufficient information on the mapping of its costs from the general ledger to FLSM asset classes such that the ACCC could scrutinise and assess:

- The traceability of operating expenditures incurred for each asset class to the general ledger;
- Whether costs incurred in Telstra's fixed line cost centres are relevant to the provision of fixed line services.

Telstra also sufficiently explained the reasons why further reconciliation of base year operating expenditure was required, which resulted in the overall operating expenditure for 2013–14 being [c-i-c starts] [c-i-c ends] per cent higher (from [c-i-c starts] [c-i-c ends] to [c-i-c starts] [c-i-c ends] in real terms) than the 2013–14 operating expenditure proposed in version 1.1 (January 2015) of Telstra's FLSM.⁴⁷

The ACCC understands that Telstra encountered numerous difficulties and limitations in its imputation of the FLSM relevant operating expenditures, and that Telstra has undertaken considerable efforts to provide an estimate of its base year operating expenditure. The ACCC acknowledges that Telstra's pervasive employment of mark-ups and cost ratios to account for its indirect costs is an indication of the extent to which Telstra could not rely on its costing system for the attribution of costs to FLSM asset classes.

Expenditure revisions

Telstra Operations business unit support mark-up

Telstra's response of 23 February sufficiently explained the calculation and reasons behind its adjustment to its Telstra Operations business unit support mark-up. Telstra also provided further information on this adjustment in its March 2015 response. The ACCC considers that Telstra's explanation for the adjustment is reasonable and that such an adjustment to its business unit support mark-up is prudent and efficient.

Telstra's proposal to allocate more ITS and TSO expenditures to FLSM asset classes

Telstra's adjustments to forecast ITS expenditure (2014–15 to 2018–19) for FLSM asset classes results in an increase in ITS FLSM expenditure from [c-i-c starts] [c-i-c ends] (January 2015 forecasts) to [c-i-c starts] [c-i-c ends].⁴⁸ This represents an increase of [c-i-c starts] [c-i-c ends] in nominal terms over the forecast period. Telstra's adjustments to forecast TSO expenditure (2014–15 to 2018–19) for FLSM asset classes results in an increase in TSO FLSM expenditure from [c-i-c starts] [c-i-c ends] (January forecasts) to [c-i-c starts] [c-i-c ends].⁴⁹ This represents an increase of [c-i-c starts] [c-i-c ends] in nominal terms over the forecast period. However, the total nominal increase of [c-i-c starts] [c-i-c ends] excludes the mark-ups added to

⁴⁷ Telstra, *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, p. 4.

⁴⁸ Telstra, Fixed Services Model v1.1 (January 2015); Telstra, Fixed Services Forecast Model v1.2 (May 2015).

⁴⁹ *ibid.*

this amount to represent the indirect costs of Telstra Operations business unit support and unattributable costs.

The ACCC is concerned that an error of such magnitude was only discovered at such a late stage and after several iterations by Telstra of its base year operating expenditure estimates. However, as KPMG and Telstra have provided additional information on the traceability and the reconciliation of the general ledger ITS and TSO expenditures to the FLSM asset classes, such that, on the basis of the information provided, the ACCC considers that KPMG's identification of the error and Telstra's correction of the error is reasonable.

Efficiency and prudence of expenditure

Fault reporting activity

In its March 2015 response, Telstra claimed that fault reporting activity, as opposed to fault rectification activity, is difficult to allocate to a particular asset class. Therefore, for the purposes of including these costs in the FLSM, Telstra considered these costs to be CSD indirect costs which are allocated to FLSM asset classes on the basis of the corresponding direct operating expenditure for each asset class.⁵⁰

In the attribution of CSD operating expenditure by activity type and product type, Telstra allocates [c-i-c starts] [c-i-c ends] per cent of fault activity expenditure to FLSM asset classes. However, over [c-i-c starts] [c-i-c ends] per cent of CSD fault reporting activity costs are allocated to non-FLSM products.⁵¹ The ACCC is concerned that Telstra has not explained why the cost of indirect CSD fault reporting activities is not proportional to the cost of direct fault rectification activities, particularly given that Telstra employs the proportional allocation rules as a proxy for many of its indirect costs.

If there are Activity Based Management codes (employed by Telstra to attribute general ledger expenditures to FLSM asset classes) which attribute this indirect fault reporting activity almost exclusively to services related to the FLSM, Telstra should provide this ABM code information to support its approach.

Allocation of network building costs using electricity usage

On the basis of Telstra's estimates of asset electricity use, [c-i-c starts] [c-i-c ends] per cent of total Network buildings/support costs are allocated to FLSM asset classes.⁵² WIK-Consult's advice to the ACCC for the draft decision was that, floor space, not electricity usage, is the appropriate driver of building outgoings and rent.⁵³ WIK-Consult's recommendation of using floor space as the driver of rent and building outgoings is also supported by cost accounting literature. Floor space cost drivers even include electricity costs required for air conditioning, lighting, insurance, security and maintenance.⁵⁴ Rent and building outgoings such as maintenance and insurance are more likely to be dependent on the size of the building than on the electricity used within the building.

The ACCC considers that Telstra's draft decision submission comparison of the supplementary data with its NECM approach to the allocation of network building costs helps somewhat to defend the reasonableness of its approach to the allocation these Networks expenditures to FLSM asset classes. The use of alternative asset allocators sees higher percentages of

⁵⁰ Telstra, *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, p. 14.

⁵¹ *ibid*, p. 20.

⁵² *ibid*, p. 39.

⁵³ Wik-Consult (2015), *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, Bad Honnef, March 2015, p. 52.

⁵⁴ Robert Kaplan and Robin Cooper (1998), *Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance*, Harvard Business School Press, Boston, p. 32; p. 263, John Daly (2002), *Pricing for Profitability: Activity-Based Pricing for Competitive Advantage*, John Wiley and Sons, New York, p. 106; 125; Institute of Management Accountants (2006), 'Implementing Activity Based Costing', *Statements on Management Accounting Strategic Cost Management*, p. 31.

accommodation costs allocated to FLSM asset classes than that with the NECM. One major exception is property rental, for which an alternative allocator could not be found.⁵⁵ If only a minor amount of property rental expenses of [c-i-c starts] [c-i-c ends] in FY2014 is related to the FLS as opposed to other services (such as mobile services) it is still possible, however, that the accommodation cost allocated to the FLS on the basis of the NECM proxy of [c-i-c starts] [c-i-c ends] per cent is an overestimate. It would be desirable for Telstra to provide further evidence on what types of property rental expenses it incurs for FLS in response to the further draft decision.

ITS and TSO allocators

The ACCC notes Optus' concern in relation to the calculation of the percentage allocation of ITS expenditures to FLSM asset classes (originally [c-i-c starts] [c-i-c ends] per cent) failing to match hardcoded fixed line ITS expenditures as percentage of total ITS costs ([c-i-c starts] [c-i-c ends] per cent) for 2013–14.⁵⁶ Telstra's May 2015 operating expenditure forecasts have addressed this anomaly by removing base year hardcoded estimates and calculating base year fixed line ITS operating expenditures on the basis of the allocation factors.

The ACCC considers that KPMG's recommendation to only use 2013–14 ITS and TSO allocator values is an improvement in the expenditure allocation for the 2013–14 base year and the years 2014–15 to 2018–19. Since the ITS and TSO allocator values decline quite sharply from 2012–13 to 2013–14, and since it is conceivable that, as demand for fixed line services decline, the allocator values are more likely to decrease than increase in the future, the use of 2013–14 allocator values alone is likely to yield a more accurate allocation of ITS and TSO expenditures than a historical average of 2012–13 and 2013–14 allocator values.

The NERA benchmarking report

The ACCC notes the NERA report which found that on the basis of benchmarking BT's and Telstra's operating expenditures for equivalent wholesale services, NERA found Telstra's 2013–14 base year operating expenditure to be comparable on a per unit basis.⁵⁷

While there are residual issues of comparability of the two companies that were not controlled for in the study (the asset valuation framework and differences in scale economies and customer density) these are considered to constitute a basis for Telstra having higher unit costs than BT. The study therefore provides a degree of support that Telstra's cost estimates for the regulated FLS are prudent and efficient.

ACCC further draft decision: efficiency and prudence of base year expenditure

As noted above, the ACCC accepts that Telstra as a whole has incentives to operate efficiently, but that it has incentives to inflate the costs that it allocates to the FLS for the purpose of regulated FLS pricing. It was due to concerns about the lack of information on the allocation of Telstra's costs to the FLSM that the ACCC was not prepared to come to a draft decision about the prudence and efficiency of base year and forecast expenditures.

In response to these concerns about traceability and relevance expressed in the March draft decision, Telstra has provided a comprehensive mapping of its expenditures from general ledger to FLSM asset classes and subjected these to review by KPMG. Telstra has also provided other information to further explain its allocations and to cross-check these with other allocation methodologies.

⁵⁵ Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, Confidential Version, Appendix 4, pp. 245-248.

⁵⁶ Optus, *Submission in response to ACCC Draft Decision*, Public inquiry into final access determinations for fixed line services – primary price terms, Confidential Version, April 2015, p. 80.

⁵⁷ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, Appendix 14.

With the exception of a few gaps in this information that have been noted, this further information provides the ACCC with comfort about the reasonableness of Telstra's costs allocations to the FLSM, including Telstra's revisions to its costs including the adjustment to its business unit support mark-up (adding approximately \$[c-i-c starts] [c-i-c ends] million in real terms over the forecast period).⁵⁸

The ACCC's further draft decision is, on the basis of the additional information Telstra has provided since the draft decision, to accept Telstra's base-year operating expenditures for 2013–14 as both prudent and efficient. However, this decision is contingent on Telstra providing the ACCC with ABM code information to support its approach for allocating the indirect costs of fault reporting activity to FLS and to explain what property rental costs are incurred by the FLS.

2.3.3 The responsiveness of Telstra's operating expenditure to changes in demand

2.3.3.1 ACCC draft decision

The ACCC draft decision outlined a number of concerns in relation to the responsiveness of Telstra's forecast operating to changes in demand.

The ACCC observed that Telstra's adoption of the base-step-trend framework for its operating expenditure was incomplete. The trend component of the framework involves the regulated business linking the scale of its operations to the size of the network. However, with the exception of several activities in CSD and the Wholesale Group, Telstra had not linked the scale of operations to the size of its fixed line network.

As a result of Telstra's incomplete implementation of the base-step-trend framework the ACCC could not verify Telstra's forecast operating expenditures on the basis of this framework. However, Telstra's incomplete implementation of the framework did reveal where the information gaps existed. The ACCC noted that more information on how network size changes the scale of operations for the fixed line cost centres of Networks, ITS, TSO and propex (and certain activities for CSD) would improve the transparency and verifiability of how Telstra's forecast operating expenditures respond to changes in forecast demand.

The ACCC was also concerned that Telstra had not been able to provide sufficient information on why many of its cost centre's costs fail to change in response to the decline in the operations for FLSM asset classes, both absolutely and relative to its other operations. The ACCC had specific concerns in relation to Telstra's lack of explanation of the unresponsiveness of ITS, TSO and certain Networks operations to the forecast decline in the size of Telstra's fixed line network. Therefore, the ACCC found it difficult to determine whether the responsiveness of Telstra's cost centres to changing demand is reasonable and whether operating expenditure forecasts are prudent and efficient.⁵⁹ However, the ACCC noted that it would consider this issue again after receiving further information from Telstra and submissions from stakeholders.⁶⁰

The ACCC decided not to incorporate Telstra's 6 February 2015 response into the draft decision. The ACCC's assessment was based on Telstra's submissions and responses up until January 2015. In forming this draft decision, the ACCC had balanced the risk of double counting the cost arising from the potential inclusion of connection/disconnection costs in CSD

⁵⁸ Telstra, Fixed Services Forecast Model, v1.2 (May 2015). The exclusion of NBN-specific propex by the ACCC means that the actual dollar amount included in the further draft decision forecasts is slightly lower.

⁵⁹ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, pp. 34-46.

⁶⁰ *ibid*, p. 46.

against the largely unexplained uplift in Telstra's propex that it proposed in its 6 February 2015 response.⁶¹

2.3.3.2 Telstra's response to the draft decision

Telstra structured its response to the ACCC draft decision to address the ACCC's and WIK-Consult's key concerns relating to the responsiveness of the following cost centres to changes in fixed line demand arising from the NBN rollout: Networks, ITS and TSO.

Networks

Telstra submitted that the nature and timing of the NBN rollout will prevent Telstra from decommissioning any material part of its legacy network over the regulatory period. Telstra stated that the cost of rationalising and moving active services overwhelms any operating expenditure savings from rationalisation if Telstra was able to partially or fully exit exchanges. Further, Telstra submitted that it is not feasible to rationalise, sub-divide or sell exchanges until all services are fully migrated. For example, Telstra stated that on the basis of NBN's rollout forecast, by the first quarter of 2018, less than [c-i-c starts] [c-i-c ends] per cent of ESAs will have at least [c-i-c starts] [c-i-c ends] per cent of premises they are currently servicing covered and migrated to NBN and therefore there is no meaningful scope to rationalise equipment during the regulatory period.⁶²

Telstra also submitted that network equipment including DSLAMs, switching equipment, transmission equipment, is not expected to be reduced, and that to the extent that this equipment becomes relatively less utilised over the forecast period, the electricity, maintenance and other costs associated with this equipment will not fall.⁶³ Telstra provided an analysis illustrating the relationship between the actual loss of SIOs as a result of the NBN rollout and actual changes in power consumption for various ESAs. This analysis showed that irrespective of the SIO decline within an ESA, power usage remains relatively flat.⁶⁴

ITS

In response to the draft decision which raised concerns about the lack of responsiveness of ITS expenditures to the forecast decline in the size of the fixed line network, Telstra submitted that there will be no expected reduction in its ITS costs as a result of the SIO migration to NBN. Telstra expects that it will still be operating largely the same number of exchange buildings, the same number of PSTN switches, DSLAMs, transmission infrastructure and associated fixed line network equipment. Telstra stated that it will still be supplying the same range of regulated and non-regulated services over the fixed line network.⁶⁵ Telstra provided information that details how and why the Telstra's expenditure on ITS is unlikely to respond to the fall in SIO volumes over the forecast period.⁶⁶

TSO

In response to the draft decision which raised concerns about the lack of responsiveness of TSO expenditures to the forecast decline in the size of the fixed line network, Telstra stated that the key drivers of TSO expenditures are not SIO volumes, but rather the complexity of Telstra's network and the number of actively monitored network elements.⁶⁷ Telstra submitted that Telstra's fixed line network in 2018–19 will remain in substantially the same configuration as is the case currently.⁶⁸ It argued that reductions in SIOs do not lead to a reduction in the

⁶¹ *ibid.*, p. 46.

⁶² Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 74 and Appendix 15.

⁶³ *ibid.*, p. 84.

⁶⁴ *ibid.*, pp. 97-106 and Appendix 5.

⁶⁵ *ibid.*, pp. 107-108.

⁶⁶ *ibid.*, p. 110.

⁶⁷ *ibid.*, p. 112.

⁶⁸ *ibid.*, Appendix 15.

scale and scope of the network and consequently do not influence the number of monitored network elements that TSO must manage.⁶⁹ It explained that TSO expenditure relates to monitoring of and responses to large-scale problems that arise in the network and not premises-specific faults.⁷⁰

2.3.3.3 Other stakeholder responses to the draft decision

Frontier

Frontier was concerned that there is a lack of relationship between operating expenditure forecasts and the cost drivers behind it, including assets deployed and the volumes of services.⁷¹

It proposed a ‘top down’ method as a short-term solution to deriving suitable forecasts of operating expenditure and capital expenditure. This would require that the ACCC seek further information from Telstra to better satisfy itself of the efficiency and prudence of base-year costs and then forecast aggregate operating expenditure and capital expenditure for each year in proportion to the changes in the number of SIOs due to the NBN roll-out.⁷²

Frontier’s estimates of forecast operating expenditure using its top down methodology (based on no adjustments to existing base year costs) and no change in fault rates are shown in Table 2.3 below.

Table 2.3 Frontier’s estimates of forecast operating expenditure using its top down methodology [c-i-c starts]

	2015-16	2016-17	2017-18	2018-19
Opex (ACCC)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Opex (Top down, SIO linked)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

[c-i-c ends] Source: Frontier, *Submission on the ACCC’s draft decision on fixed line prices, A Report Prepared For the Competitive Carriers Coalition, iiNet and Optus*, May 2015, p. 29.

Optus

Optus submitted that it is concerned that the absence of any cost-volume relationships means that forecasts cannot be verified.⁷³ Further to this, it was concerned that Telstra’s forecasts have not identified key operating expenditure drivers and the forecast expenditures do not adequately respond to changes in demand for fixed line services. This was considered of significance given the expected decline in fixed line demand over the forecast period.⁷⁴

⁶⁹ *ibid*, p. 113.

⁷⁰ *ibid*, p. 114

⁷¹ Frontier, *Submission on the ACCC’s draft decision on fixed line prices, A Report Prepared For the Competitive Carriers Coalition, iiNet and Optus*, May 2015, pp. 20-21.

⁷² *ibid*, p. 29.

⁷³ Optus, *Submission in response to ACCC Draft Decision, Public Inquiry into final access determinations for fixed line services – primary price terms*, Confidential Version, April 2015, pp. 56-59.

⁷⁴ *ibid*, pp. 61-62.

Optus proposed that Telstra provide more information so that the ACCC can develop its own set of forecasts, and if this is not forthcoming, that the ACCC maintain the FY2014 operating expenditure to SIO ratio throughout the forecast period.⁷⁵

Optus had some specific concerns about the levels and non-responsiveness of Telstra's Service Operations costs including for CSD, Network, ITS and TSO.

In relation to CSD Fault costs, Optus considered [c-i-c start] [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] [c-i-c ends]

For other CSD maintenance expenditure, Optus noted the Telstra forecasts show little relationship between volumes of SIOs or other volume metrics (e.g. copper line length) and the level of this maintenance expenditure.⁷⁷

In relation to Network costs, Optus was concerned that the forecast for nominal operating expenditure remains relatively flat over the forecast period, reflecting an indexing approach to these costs rather than a considered assessment of how these costs are likely to trend over time to reflect network cost-volume relationships and asset utilisation, with power consumption costs being a major example.⁷⁸ Optus was critical of the indexes used for rents and building outgoings, the allocation of building costs according to power consumption (that serves to increase the allocation of building costs to the CAN relative to the Core) and the absence of building disposals.⁷⁹

In respect to ITS costs, Optus was concerned that the allocation percentages to the fixed line services remain static in the forecasts from year to year (noting that they have varied historically by year). It also considered the allocations of particular ITS costs to the fixed line services have not been adequately detailed. It further noted that even if ITS costs shared between the fixed line services and other services were to remain unchanged in the face of declining demand for fixed line services, it would be expected that other services should bear more of these costs over time.⁸⁰ Optus also identified an error in Telstra's cost allocation of ITS expenditure to FLSM asset classes. Based on the forecast model, the total ITS operating expenditure for 2013-14 only represents [c-i-c starts] [REDACTED] [c-i-c ends] per cent of total ITS costs not [c-i-c starts] [REDACTED] [c-i-c ends] per cent as presented in the allocation matrix for ITS costs.⁸¹

For TSO costs, Optus was concerned that each of the costs categories are simply increased from base year amounts with little consideration or explanation given of the allocation approach to fixed line services, the impact changes in fixed line demand and that the costs allocated to fixed line services do not reflect Telstra's broader annual efficiency target for TSO costs overall.⁸²

Optus was also concerned about the method by which indirect operating expenditure has been included in the forecasts. These included concerns that the proportion remains constant for all individual business units over the forecast period and the means by which the mark-ups were applied. It noted that the base year values changed several times, providing grounds to have little confidence in the estimates.⁸³

⁷⁵ *ibid*, p. 64.

⁷⁶ *ibid*, p. 69.

⁷⁷ *ibid*, pp. 72-74.

⁷⁸ *ibid*, pp. 75-79.

⁷⁹ *ibid*, pp. 77-78.

⁸⁰ *ibid*, pp. 79-81.

⁸¹ *ibid*, p. 80.

⁸² *ibid*, pp. 81-82.

⁸³ *ibid*, pp. 83-87.

Overall Optus submitted that many of Telstra forecasts of operating expenditure do not represent prudent cost management in an environment of significant reduction in demand and the ACCC should not accept them. It proposed that the ACCC develop its own independent forecasts and place the onus of proof on Telstra to convince the ACCC why its own contrary forecasts would be more appropriate.⁸⁴

iiNet

iiNet submitted that the ACCC should do more than provide Telstra with an opportunity to 'shore up' its forecasts.⁸⁵

iiNet supported the recommendations of Frontier Economics in relation to the establishment of independent base year expenditures and forecasts (including the use of 'top down' approach to reflect the change in the number of SIOs with the roll out of the NBN) on the basis that it had little confidence that the levels and the allocations of cost to the declared services are prudent and efficient.⁸⁶

2.3.3.4 ACCC further draft decision assessment: responsiveness to demand

Networks

Telstra's submission on the nature and timing of the NBN rollout and its effect on Networks expenditures presented strong evidence that Telstra has limited ability to rationalise, sub-divide or sell its exchanges until all services are fully migrated. Since nearly all ESAs will still provide legacy services by 2018–19, the ACCC considers that Telstra will have limited scope to rationalise and avoid operating expenditures for its Networks cost centre. Telstra's explanations and evidence that equipment removal is likely to be minimal or, at best, piecemeal over the forecast period, and Telstra's evidence that power usage is unlikely to decline in exchange buildings as a result of the rollout, has sufficiently addressed ACCC's concerns relating to the relative unresponsiveness of the Networks cost centre expenditures to the decline the size of Telstra's legacy network.

ITS

In its draft decision response, Telstra has provided considerably more information on the nature of its ITS expenditures and operations and how these expenditures are allocated to asset classes. Telstra has sufficiently explained how its FLSM-relevant ITS expenditures are unlikely to fall over the forecast period because the infrastructure necessary for the ongoing provision of fixed line services and which consume ITS activities and resources – such as exchange buildings, PSTN switches, DSLAMs, transmission infrastructure and associated fixed line network equipment – is unlikely to decline as a result of the NBN rollout over the forecast period.⁸⁷ The ACCC considers that Telstra provided comprehensive information that details how and why Telstra's expenditure on ITS is unlikely to respond to the fall in SIO volumes over the forecast period.⁸⁸

TSO

In response to the draft decision which raised concerns about the lack of responsiveness of TSO expenditures to the forecast decline in the size of the fixed line network, Telstra stated

⁸⁴ *ibid*, pp. 87-88.

⁸⁵ iiNet, *Public inquiry into final access determinations for fixed line services – primary price terms*, Draft Decision, March 2015, Confidential Version, p. 5.

⁸⁶ *ibid*, pp. 4-5.

⁸⁷ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, pp. 107-108.

⁸⁸ *ibid*, p. 110.

that the key drivers of TSO expenditures are not SIO volumes, but rather the complexity of Telstra's network and the number of actively monitored network elements.⁸⁹

It backed this up with evidence that:

- over the forecast period the configuration of its network will remain largely the same as it is currently – Telstra will continue to operate a national network of PDN, SDH and xWDM transmission systems which interconnect [c-i-c starts] [c-i-c ends] local exchanges, [c-i-c starts] [c-i-c ends] PSTN nodes, [c-i-c starts] [c-i-c ends] active network elements and Telstra's ADSL infrastructure of [c-i-c starts] [c-i-c ends] DSLAMs.⁹⁰
- the number of network elements had hardly changed in the past three years – by ([c-i-c starts] [c-i-c ends] out of more than [c-i-c starts] [c-i-c ends]).
- over the period March 2013 to March 2015, no relationship existed between the number of alarms raised for PSTN network elements – which is a cause of TSO expenditures – and the number of SIOs.⁹¹

Overall the ACCC considers that Telstra has provided sufficient information and evidence on the non-responsiveness of Network, ITS and TSO operating expenditures to the number of SIOs, and that the decline in the number of legacy SIOs is therefore unlikely to reduce operating expenditure outlays substantially.

The ACCC has, however, decided to make an adjustment to asset class cost allocations to account for the impact on unit costs of a loss of economies of scale due to migration of services to the NBN. Lack of responsiveness of Network, ITS and TSO operating expenditures to migration of SIOs to the NBN is captured by that adjustment. . This is detailed in chapter 4 of the further draft decision. This adjustment conforms with the intent of, but is considered to be more robust than, the 'top-down' approach proposed by Frontier Economics and iiNet to scale-down Telstra's forecast expenditures proportionately to reduce SIOs with the NBN roll-out.

ACCC's further draft decision on responsiveness of forecast operating expenditures to changes in demand

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.^{92, 93}

Scope for such discretion may elevate the risk of Telstra proposing to include imprudent and inefficient expenditures in the FLSM.

⁸⁹ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 112.

⁹⁰ *ibid*, p. 113.

⁹¹ *ibid*, p. 114.

⁹² For example, Telstra has claimed that its particular choices of allocation methods for Networks resulted in [c-i-c starts] [c-i-c ends] less FLSM operating expenditure for 2013–14 and possibly several times that amount for its forecast operating expenditure over the forecast period. Telstra (2015), *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 18.

⁹³ Telstra has also stated that it may include considerably more FLSM relevant operating expenditure in the future. For example, through further analysis of its general ledger in response to the draft decision, Telstra has identified a further [c-i-c starts] [c-i-c ends] that may be relevant to FLSM asset classes that it has decided not to include because more thorough analysis is required. Telstra also stated it did not have time to review other business units where even further FLSM relevant operating expenditure may be identified. Telstra (2015), *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 8, p. 220.

However, Telstra has provided the ACCC with considerably more information on:

- the mapping of its operating expenditures from general ledger to FLSM asset classes for the base year, and
- how particular technical constraints and the nature of the NBN rollout may inhibit Telstra from substantially reducing its network operating expenditures over the forecast period.

On the basis of the further information Telstra has provided, and the adjustment that is made to overall expenditures to account for the loss of economies of scale due to the NBN, the ACCC's further draft decision is that it accepts Telstra's forecast operating expenditures as prudent and efficient.

2.3.4 Propex

2.3.4.1 ACCC draft decision

In the draft decision, the ACCC raised a number of concerns about prudence and efficiency of Telstra's proposed propex and its propex forecasting methodology. The ACCC was concerned that Telstra did not provide information on how propex related to asset classes in which it was attributed – the attribution of propex from IMC codes to asset classes was insufficiently explained and justified.⁹⁴

The ACCC was also concerned that Telstra had not sufficiently demonstrated how propex incurred for an asset class related to asset replacement/operational support (AROS), demand driven, discretionary and NBN-related capital expenditures. In the absence of this information, the ACCC was concerned that the addition of a separate propex expenditure included in capital expenditure forecasts for some asset classes may risk double counting the labour and intermediate input component that is already capitalised in capital expenditure forecasts.⁹⁵ WIK-Consult shared the concerns of the ACCC. For example, it raised that Telstra should ensure that expenses on asset remediation are not counted twice, once as operating expenditure and once as capital expenditure.⁹⁶

The ACCC had further concerns in relation to Telstra's propex forecast methodology. The forecast propex amount for each asset class is based on the historical propex share of capital expenditure that is then multiplied by forecast capital expenditure for that asset class. However, Telstra had not demonstrated how this particular methodology is appropriate for anticipating future propex requirements for each asset class.⁹⁷ WIK-Consult was also concerned that Telstra's forecast of propex is highly sensitive to the sequence of capital expenditures that Telstra has estimated for the years 2011–12 to 2013–2014 and as a result the forecasts of propex did not appear plausible.⁹⁸

The ACCC's draft decision was that it could not form a view on the prudence and efficiency of Telstra's proposed propex since there was insufficient information and transparency on what is causing these costs to be incurred. The ACCC's draft decision was to not make adjustments to Telstra's forecast propex. The exception to this was the removal of NBN-related propex.⁹⁹

⁹⁴ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, pp. 51-54.

⁹⁵ *ibid.*, pp. 51-54.

⁹⁶ WIK-Consult, *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, Bad Honnef, March 2015, p. 36.

⁹⁷ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, pp. 51-54.

⁹⁸ WIK-Consult, *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, Bad Honnef, March 2015, pp. 71-77.

⁹⁹ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, pp. 51-54.

2.3.4.2 Telstra's 6 February 2015 response

In its 6 February 2015 submission,¹⁰⁰ Telstra advised it had erroneously omitted propex for asset classes CA07, CA09, CA10, CO07, CO09 and CO10 and supplied propex against these asset classes. Telstra also made further changes to its 19 and 30 January 2015 submissions for propex.¹⁰¹

In addition Telstra identified an error in the attribution of NBN-related capital expenditure to asset classes. As a result, Telstra allocated NBN-related capital expenditure from CA07 (other communications plant and equipment) and CA09 (Network Buildings Support) to CO07 (other communications plant and equipment) and CO09 (Network Buildings Support).¹⁰² This automatically changed the amount of propex attributed to these asset classes.

Telstra also adjusted propex for CA01 ducts and pipes and CA02 copper cables for the years 2011–12 to 2014–15. There was a substantial increase in propex for CA01 ducts and pipes and an offsetting decrease in propex for CA02 copper cables between 2011–12 and 2014–15. This translated into a substantial increase in the propex share of capital expenditure for CA01 and a substantial decrease in the propex share of capital expenditure for CA02 over these years.

As a result of recording propex against six additional asset classes, Telstra identified a risk of double counting operating expenditures for these asset classes and their relevant cost centres.¹⁰³ Therefore, Telstra deducted the 2013–14 base year fixed line propex amount from the operating expenditures for the relevant cost centres: CSD; Networks; TSO and ITS.¹⁰⁴

2.3.4.3 Telstra's 12 March 2015 response

In March 2015, Telstra provided further explanation of its rebased 2013–14 operating expenditure. Telstra provided a mapping of its operating expenditure relevant to fixed line services from its expenditure accounts in the general ledger to the operating expenditures for each asset class.¹⁰⁵

In this response, Telstra submitted further information on how it attributed propex to asset classes. In particular, Telstra provided a detailed explanation of propex that resides within its originating cost centres of CSD, Networks, ITS and TSO.¹⁰⁶ Telstra undertook an extensive identification and estimation of the propex from within these cost centres so that these expenditures could be removed and allocated to capital expenditure projects for forecasting purposes.

Telstra submitted that propex is inherently linked to capital projects and for internal consistency in the level of propex forecast with respect to the forecast level of capital expenditure, Telstra made use of propex amounts derived from the capital expenditure forecast model as opposed to the propex recorded with other operating expenditure within the general ledger for individual lines of business.¹⁰⁷

For each FLSM-relevant capital expenditure project by IMC code, the amount of propex was identified as well as the sponsoring organisational unit for the capital projects classified under

¹⁰⁰ This submission is available on the ACCC's website.

¹⁰¹ This submission is available on the ACCC's website.

¹⁰² Telstra, Amendments to the Fixed Line Services Model, 6 February 2015, p. 14.

¹⁰³ *ibid.*, p. 8.

¹⁰⁴ Comparison of Telstra (2015) Fixed Services Forecast Model v1.1 (Jan2015) and Telstra (2015) FLSM FY2015 to FY2019, v1.1, C-I-C.

¹⁰⁵ Telstra, *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence.

¹⁰⁶ *ibid.*

¹⁰⁷ *ibid.*, p. 87.

each IMC. The distribution of project sponsorship for the overall IMC was then used to distribute capital expenditure with respect to that IMC relevant to the FLSM asset classes.¹⁰⁸

Capital expenditure and associated propex information was extracted from the same source [c-i-c starts] [c-i-c ends]. [c-i-c starts] [c-i-c ends] took extracts from [c-i-c start] [c-i-c end] (where the general ledger bookings are made) and [c-i-c starts] [c-i-c ends] (where the project details are located) and mapped the data together that enabled Telstra to analyse the data.

Telstra provided a mapping of IMC codes for FLSM-relevant capital expenditure (and therefore propex) which also identified the proportion of capital expenditure relevant to the FLSM on the basis of its attribution to FLSM asset classes and the corresponding proportion of propex considered relevant to the FLSM. In order to distribute the relevant propex to FLSM asset classes, the capital expenditure model distributed propex for each IMC on the basis of the distribution of capital expenditure with respect to that IMC.¹⁰⁹

Since Telstra's asset register does not differentiate between CAN and Core for the asset classes Other Communications Plant and Equipment, Network Land, Network Buildings/Support and Indirect Capital Assets, the ratios applied by the ACCC in the original FLSM were used to split the total propex for these asset classes.¹¹⁰

2.3.4.4 Telstra's response to the draft decision

In its response to the draft decision, Telstra provided further information on propex, and identified all the originating cost centres from which propex spends were extracted.

Telstra explained that there was no risk of double counting propex and capital expenditure since expenditure on a project will be classified as either propex or capital expenditure. Telstra also clarified its use of the term 'capital project'. It stated that capital project does not necessarily mean that all expenditure is capital expenditure. Rather it means that the project requires approval through Telstra's internal processes. Many projects include both capital and operating expenditure.¹¹¹

Telstra further added that it strictly adheres to its capitalisation policy in classifying project-related capital expenditure as propex or capital expenditure.¹¹²

Telstra adopted KPMG's recommendation that Telstra Operations (TO) business unit support costs should also be attributed to propex. This resulted in an increase in operating expenditure by [c-i-c starts] [c-i-c ends] for the 2013–14 base year¹¹³ and similar, albeit gradually declining, annual operating expenditure increases from 2014–15 to 2018–19 (since it is a mark-up of [c-i-c starts] [c-i-c ends] per cent applied to a falling annual propex amount).

KPMG also identified an unreconciled difference in propex adjustments, which resulted in an understatement of attributable operating expenditure of approximately [c-i-c starts] [c-i-c ends].¹¹⁴ However, Telstra took no action to correct the understated expenditure since the amount is negligible.¹¹⁵

¹⁰⁸ *ibid*, p. 88.

¹⁰⁹ *ibid*, p. 93.

¹¹⁰ *ibid*, p. 93.

¹¹¹ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 122.

¹¹² *ibid*, p. 123.

¹¹³ *ibid*, pp. 69-70.

¹¹⁴ *ibid*, p. 57.

¹¹⁵ *ibid*, p. 70.

within these cost centres so that these expenditures could be removed and allocated to a propex 'cost centre' for the purposes of forecasting.

The removal of these expenditures was necessary to avoid the risk of double counting propex since Telstra estimated propex as an independent expenditure category, where the forecast of propex was instead derived from the FLSM capital expenditure forecast model.

Telstra provided a breakdown of fixed line propex that was identified for each cost centre. This is shown in the middle column of Table 2.4 below. Approximately [c-i-c starts] [c-i-c ends] of propex for 2013–2014 was derived from 'Other Lines of Business'. However, Telstra did not identify these other lines of business and the relevance to FLSM asset classes.

Table 2.4 Telstra's proposed propex by cost centre (2013–14, million \$ nominal) [c-i-c starts]

Cost Centre	Telstra's March 2015 response	Telstra's Draft decision response)
[REDACTED]	[REDACTED]	[REDACTED]

[c-i-c ends] Source: Telstra (2015), *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, p. 88 and KPMG (2015), *The basis for determining Telstra's base year operating expenditure for fixed line services*, Gilbert and Tobin, April 2015, p. 138.

Telstra's response to the ACCC draft decision (including advice from KPMG) only partially alleviated the ACCC's concerns relating to propex from 'other lines of business'. The revised breakdown of the propex spend by originating cost centre is provided in the right hand column of Table 2.4 above. The propex spend for the 2013–14 base year of [c-i-c starts] [c-i-c ends], and most of the propex originating from Telstra's previously identified 'other lines of business' in fact originates from the ITS cost centre.¹²⁴ The reason for this is not made explicit however, and does not seem to reflect the nature of the majority of these expenditures based on IMC code.¹²⁵

It also appears that, given the upwards adjustment to the TSO cost centre, some of the propex previously attributed to the 'other lines of business' may also be attributed to the TSO cost centre.

Telstra has also reduced total base year propex by [c-i-c starts] [c-i-c ends], which results in a reconciliation between the base year propex amounts for both its March 2015 submission and its May 2015 response to the draft decision. It seems that Telstra's adjustment

¹²⁴ KPMG, *The basis for determining Telstra's base year operating expenditure for fixed line services*, Gilbert and Tobin, April 2015, pp. 94, 138.

¹²⁵ See Telstra, *Further explanation of FY2014 operating costs identified as relevant to the FLSM*, March 2015, commercial-in-confidence, Annexure 12.

of [c-i-c starts] [c-i-c ends] has been undertaken to reconcile its March 2015 and May 2015 submissions on propex.

Compared to the March 2015 submission Telstra has also re-estimated the propex spends arising from the ITS and TSO cost centres. The ACCC is concerned that the adjustments undertaken by Telstra highlights the fact that Telstra has a considerable degree of latitude and discretion around its estimates of propex for the base year (and accordingly its forecast of propex).

However, the ACCC also considers that since January 2015, Telstra (and KPMG) have provided substantially more detailed information on the relevance of propex in the provision of fixed line services, and the ACCC can now cross-check propex by IMC code and FLSM asset class, and, for the large part, cross-check propex by IMC code, FLSM asset class and originating cost centre.

ACCC further draft decision on efficiency and prudence of propex

The ACCC considers that in its responses and submissions since February 2015, Telstra has provided a reasonable explanation and information on the relevance of non-NBN specific propex for all the FLSM asset classes in which propex is attributed.

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.¹²⁶

In consideration of the further information that Telstra has provided in March and May 2015, ACCC accepts Telstra's proposal to include propex for asset classes CA07, CA09, CA10, CO07, CO09 and CO10. The ACCC also notes that Telstra's original BBM RKR response had included a mapping of propex to these asset classes and that Telstra had erroneously omitted these expenditures in its October 2014 and January 2015 forecasts.¹²⁷

On the principle of cost causality, the ACCC also considers that KPMG's recommendation is appropriate – that TO business support costs should also be attributed to propex ([c-i-c starts] [c-i-c ends] for the 2013–14 base year¹²⁸). While propex is extracted from CSD, Networks, ITS and TSO and linked to forecast capital expenditure for the purposes of forecasting, propex continues to reside within these cost centres and therefore also consumes the activities and resources of TOs business unit support.

The ACCC is, however, concerned that Telstra has not sufficiently explained why between its March 2015 response and its submission on the draft decision, propex spends have been largely re-allocated to the ITS cost centre when these were previously allocated to other lines of business and many of the IMC codes seem to be at odds with this allocation.

The ACCC shares WIK-Consult's March report concerns that Telstra's forecast of propex is highly sensitive to the sequence of capital expenditures that Telstra has estimated for the years 2011–12 to 2013–2014 and as a result the forecasts of propex do not appear plausible.¹²⁹

¹²⁶ For example, Telstra has not explained how IMC propex spends relate to the FLSM asset classes in which these spends are attributed or why the ratio of propex to capital expenditure differs markedly across IMC codes. Therefore, the ACCC can only scrutinise Telstra's propex on the basis of whether its mapping of propex to FLSM asset classes correctly correspond to that of its forecast model.

¹²⁷ Telstra, *Final Access Determinations (FADs) Inquiry – additional information in response to information request under the BBM RKR*, Confidential, February 2014, p. 13.

¹²⁸ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 69.

¹²⁹ Wik-Consult, *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, Bad Honnef, March 2015, pp. 71-77.

However, the ACCC adjustments to remove NBN-related propex for the years 2011–12 to 2014–15 address this.

On the basis of the more comprehensive itemisation and mapping of propex spends provided by Telstra since the draft decision and subject to some further clarification from Telstra on the propex spends allocated to the ITS costs centre, the ACCC's further draft decision is that it accepts Telstra's forecast of non NBN-related propex as prudent and efficient.

2.3.5 The forecast fault rate

2.3.5.1 ACCC draft decision

In the draft the decision, the ACCC observed that Telstra's forecast fault rate was forecast to grow [c-i-c starts] [redacted] [c-i-c ends] from 2016–17 to 2018–19.

It was unclear to the ACCC why faults should be increasing [c-i-c starts] [redacted] [c-i-c ends] in the [c-i-c starts] [redacted] [c-i-c ends] of the forecast period when Telstra's fault remediation program continues to have an impact on fault rates in [c-i-c starts] [redacted] [c-i-c ends]. It was also unclear to the ACCC what other factors are influencing the [c-i-c starts] [redacted] [c-i-c ends] growth of fault rates other than the NBN rollout despite Telstra stating in response to the ACCC's January 2015 information request that the forecast increase of the fault rate caused by NBN is excluded from its forecast model and Telstra's official business forecasts.¹³⁰

For the purposes of the draft decision, the ACCC accepted Telstra's forecast growth of the fault rate. However, in the absence of further information from Telstra that sufficiently explains that the forecast increase in the growth rate of fault rates from 2016–17 to 2018–19 is attributable to causes other than NBN, the ACCC stated that it may make adjustments to Telstra's fault rate projections prior to making its final decision.

2.3.5.2 Telstra's response to the draft decision

In response to the ACCC concerns about the forecast rate of growth in the fault rate in the latter half of the forecast period, Telstra submitted that the key drivers of the increase in fault rate growth for the period 2016–2019 principally related to three factors:

- Ageing legacy copper infrastructure and dispersion in faults that limit benefits of joint remediation activity
- Increase in uptake of new technologies and changes in customer behaviour
- The greater proportion of ULLS services on Telstra's network, necessitating more field visits and therefore causing Telstra to incur higher costs.¹³¹

Telstra provided supporting information in relation to each of the above factors.

2.3.5.3 Other stakeholder responses to the draft decision

Frontier

[c-i-c starts] [redacted]
[redacted]
[redacted] [c-i-c ends]

¹³⁰ Telstra, *Fixed Line Services final access determination inquiry: ACCC request for information*, 33236882_5_FAD response to 14 January information request 300115 FINAL VERSION, 30 January 2015, p. 11.

¹³¹ Telstra (2015), *Public Inquiry into final access determinations for fixed line services – primary prices*, Response to Draft Decision, 1 May 2015, p. 113.

2.3.5.4 ACCC further draft decision on the forecast fault rate

The ACCC considers that Telstra has submitted sufficient information that the forecast rate of growth in the fault rate is explained by network factors alone, which rules out any anticipated growth in the fault rate that is directly caused by the NBN rollout. However, the ACCC does note that, as stated by Telstra, capital expenditure remediation work, which reduces network faults, must have a defined payback period (which may be in the form of network operating cost savings).¹³⁴ The NBN rollout is likely to increasingly truncate the payback period of such remediation programs, such that fewer programs may be undertaken or the programs may be smaller in scope. Consequently, the NBN rollout may be indirectly causing the potential escalation in the growth of fault rates.

However, while the NBN rollout may be indirectly contributing to the growth in network faults and fault rectification operating expenditure, Telstra has sufficiently demonstrated that the rollout is not a direct cause of the growth in network faults. Therefore, the ACCC's further draft decision is that Telstra's forecast operating expenditure relating to its forecast growth in the fault rate is both prudent and efficient.

2.3.6 Capex-opex trade-off

2.3.6.1 ACCC draft decision

In the draft decision, the ACCC considered that Telstra had insufficient regard to the trade-off between capital and operating expenditure across its asset classes. This was likely to result in an over-estimate of Telstra's expenditure forecasts for the next regulatory period.¹³⁵

Telstra adopted the base-step-trend approach (and refers to the AER *Better Regulation* document in its adoption of the approach¹³⁶) to its operating expenditure forecasts, and therefore there should also be a consideration of potential trade-offs between its capital and operating expenditures. However, Telstra had not included any explicit recognition of the potential trade-offs between proposed operating and capital expenditures as envisaged by the AER's base-step-trend approach.¹³⁷

For projected fault rates, Telstra acknowledged that a trade-off existed between capital and operating expenditure – Telstra's joint remediation expenditure programs were expected to

¹³² Frontier, *Submission on the ACCC's draft decision on fixed line prices, A Report Prepared For the Competitive Carriers Coalition, iiNet and Optus*, May 2015, pp. 24-25.

¹³³ Optus, *Submission in response to ACCC Draft Decision, Public Inquiry into final access determinations for fixed line services – primary price terms*, Confidential Version, April 2015, pp. 69-71.

¹³⁴ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, pp. 117-118.

¹³⁵ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, p. 57.

¹³⁶ Telstra, *Forecast Model v 1.05 Framework and Guide to Forecast Assumptions*, October 2014, Commercial in Confidence, p. 55; AER, *Better Regulation, Explanatory Statement – Expenditure Forecast Assessment Guideline*, November 2013.

¹³⁷ See for example: AER, *Final Decision, ElectraNet Transmission determination, 2013-14 to 2017-18*, April 2013; Jacobs SKM, *Attachment B17.1 Regulatory Submission Support – Phase 3, ACTEWAGL, Capex/Opex Trade-off Issues, QH10545RP0004|B*, 26 May 2014; AER, *Final Decision Electranet Transmission Determination 2013-14 to 2017-18*, April 2013, p. 27, pp. 35-37.

reduce forecast fault rates and related operating expenditures (largely for its copper network assets).

However, beyond this acknowledged trade-off there was no recognition of the trade-off between operating and capital expenditures for other asset classes.¹³⁸ The ACCC stated that the consideration of the capex-opex trade-off for Telstra fixed line operations was important because capital expenditure per fixed line SIO for both the CAN and Core is expected to increase over the forecast period, which indicates a degree of capital deepening.¹³⁹

WIK-Consult supported the ACCC's position on the requirement that adjustments for the trade-off between capital and operating expenditure be considered. WIK-Consult considered that when investment is undertaken, a new asset might be associated with less operating expenditure than a legacy asset. However, in turn, the legacy asset should be associated with a lower sum of economic depreciation and economic cost of capital. Therefore, a trade-off exists between capital expenditure and operating expenditure. The overall economic costs associated with the new asset and the legacy asset have to be identical otherwise the legacy asset would not have been attributed the value at which the firm would be indifferent between keeping the legacy asset and substituting it for the Modern Equivalent Asset.¹⁴⁰

2.3.6.2 Telstra's response to the draft decision

In response to the draft decision Telstra submitted that it does consider capex-opex trade-offs as part of its ongoing business planning and expenditure forecasting. Telstra indicated that as a result of its reduced investment in its legacy copper network, fault rates and associated operating expenditure have been increasing, which highlights the trade-off between capital expenditure and operating expenditure. Further, Telstra's investment in joint remediation programs, with the consequent reduction in fault rates and associated operating expenditure, also highlights the trade-off between forecast capital and operating expenditure.¹⁴¹

Telstra submitted that it disagrees with the ACCC over its claim that there may be a capital deepening over the period 2015–16 to 2018–19 since fixed line SIOs are falling faster than capital expenditure. Telstra stated that the forecast increase in capital expenditure per SIO is associated with loss of economies of scale. It is not due to any form of capital deepening that would reduce operating expenditure requirements such as increased spending on network remediation or rehabilitation.¹⁴²

2.3.6.3 ACCC further draft decision on the capex-opex trade-off

Since Telstra adopted a base-step-trend approach to its operating expenditure forecasts, the ACCC considered in its draft decision that Telstra should have also included an explicit recognition of the capex-opex trade-off for all FLSM asset classes where it may arise. The ACCC was concerned that Telstra provided only limited explicit recognition of this trade-off.

While capital expenditure per SIO is increasing for the fixed line network, in its submission to the draft decision Telstra has demonstrated that this is due to loss of economies of scale not due to capital deepening. Telstra has also demonstrated that the opposite of capital deepening is occurring, where over the forecast period it is substituting greater operating expenditures for its declining capital expenditure outlays, which is also evidence of a capex-opex trade-off.¹⁴³

¹³⁸ Telstra, *Forecast Model v 1.05 Framework and Guide to Forecast Assumptions*, October 2014, Commercial in Confidence, p. 32.

¹³⁹ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms, draft decision*, 11 March 2015, p. 57.

¹⁴⁰ Wik-Consult, *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, Bad Honnef, 4 March 2015, pp. 27-28; p. 118.

¹⁴¹ Telstra, *Public Inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, pp. 125-126.

¹⁴² *ibid.*, p. 126.

¹⁴³ *ibid.*, pp. 125-126.

Telstra's substantial allocation of operating expenditure to the copper cable asset class (where [c-i-c starts] [c-i-c ends] per cent of total operating expenditure is allocated to the copper cable asset class for 2013–14 base year compared to [c-i-c starts] [c-i-c ends] per cent for the FAD 2011 forecast for 2013–14) and the expected [c-i-c starts] [c-i-c ends] rate of network faults and associated operating expenditures indicates that while the trade-off is not explicitly recognised, it is occurring for asset classes where total expenditures are relatively material.

The ACCC considers that while Telstra has not explicitly recognised the capex-opex trade-off, it has appropriately considered the capex-opex trade-off in its forecast expenditures as it continues to substitute capital expenditure for operating expenditure. The ACCC's further draft decision is that Telstra has adequately accounted for any trade-off that may occur between its forecast capital expenditure and operating expenditure and that these expenditures are therefore accepted as efficient and prudent in this respect.

3 Capital expenditure forecasts

Key Points

- Telstra revised its capital expenditure forecasts in May 2015 as part of its submission to the draft decision.
- Telstra has revised down its forecast for National Broadband Network (NBN)-specific capital expenditure in response to concerns raised in the draft decision.
- For the purpose of this further draft decision, the ACCC maintains its draft decision to exclude NBN-specific capital expenditure from the fixed line services model (FLSM). This is on the basis that this expenditure is incremental for the NBN roll out and should be recovered from the NBN and its users (and not other users of the fixed line network).
- Telstra has provided substantially more information on its capital expenditure forecasts. Telstra has also responded to concerns raised in the draft decision regarding the level of transparency in relation to capital expenditure forecasts with more detailed information and explanation.
- The ACCC has undertaken a crosscheck of Telstra's capital expenditure forecasts by generating its own alternative forecasts. This supports a view that Telstra's capital expenditure forecasts are reasonable.
- The ACCC draft decision is to accept Telstra's May 2015 capital expenditure forecasts, subject to continued exclusion of NBN specific expenditure, as prudent and efficient.

3.1 Introduction

Capital expenditure forecasts are an input into the fixed line services model (FLSM) for estimating prices for the declared fixed line services. The FLSM updates the regulatory asset base (RAB) to incorporate forecast annual capital expenditure, depreciation and asset disposals for that year. Forecast capital expenditure is added to the RAB each year and forms a component of the revenue requirement through the return on and of capital.

This chapter sets out the ACCC's further draft decision on Telstra's proposed capital expenditure forecasts. All figures, tables and charts in this chapter are set out in real terms (2009 dollars).

3.2 March 2015 draft decision

The ACCC's draft decision on capital expenditure forecasts was based on information submitted by Telstra up to 30 January 2015. Thus, the draft decision was based on incomplete information as the ACCC had not yet assessed Telstra's submissions made in February and March 2015 and was still awaiting further information from Telstra.

The ACCC identified four main issues with Telstra's revised capital expenditure forecasts:

- The methodology for forecasting capital expenditure does not provide sufficient evidence on the linkage between cost drivers and the forecasts
- A relatively stable capital expenditure forecast for the transmission equipment asset class appears problematic in combination with [c-i-c starts]

[c-i-c ends]

- 2015–16 to 2018–19 forecasts were largely estimated on the basis of historic and forecast trends,¹⁴⁸ as well as anticipated future requirements and the assumed impact of the NBN rollout.
- In undertaking trend analysis, IMC-level capital expenditure was aggregated from different funding types (demand-driven, asset replacement and operational expenditure (AROS), discretionary and NBN-specific).

The ACCC was concerned with Telstra’s use of [c-i-c starts] [REDACTED]

[REDACTED]

[c-i-c ends] The ACCC noted that an appropriate forecast of capital expenditure would be based on a forecast of cost driver volumes (i.e. demand for fixed line services and asset quantities) and a functional relationship between the cost driver volume and the amount of capital expenditure.¹⁵¹

Further, the ACCC noted that, for the capital expenditure forecasts, Telstra has adopted [c-i-c starts] [REDACTED] [c-i-c ends] Telstra’s forecast model ‘capped’ the growth rate of [c-i-c starts] [REDACTED] [c-i-c ends] capital expenditure [c-i-c starts] [REDACTED]

[REDACTED] [c-i-c ends]

As a result, the ACCC considered that Telstra’s proposed capital expenditure forecast methodology does not provide sufficient evidence on the linkage between cost drivers and the forecasts. Thus, the ACCC was unable to form a view on the reasonableness of Telstra’s capital expenditure forecast methodology based on the information available to it.¹⁵³

3.2.2 Certain demand-related capital expenditure

The ACCC was concerned with Telstra’s proposed [c-i-c starts] [REDACTED] [c-i-c ends] capital expenditure for the transmission equipment asset class for 2014–15 to 2018–19 and its allocation to the regulated fixed line services.¹⁵⁴

The ACCC considered that, for transmission equipment, [c-i-c starts] [REDACTED]

- [REDACTED]

¹⁴⁸ [c-i-c starts] [REDACTED] [c-i-c ends]

¹⁴⁹ ACCC, Draft decision, March 2015, p. 68.

¹⁵⁰ *ibid.*

¹⁵¹ *ibid.*, pp. 67–71.

¹⁵² *ibid.*, p. 68.

¹⁵³ *ibid.* pp. 67–71.

¹⁵⁴ *ibid.*, pp. 73–76.

¹⁵⁵ *ibid.*, p. 75.

- [redacted]
[redacted]
[redacted] [c-i-c ends]

For transmission equipment, the ACCC considered that Telstra’s methodology for forecasting capital expenditure does not provide evidence on the linkage between demand-related capital expenditure forecasts and the [c-i-c starts] [redacted] [c-i-c ends] allocation to the declared fixed line services. As a result, the ACCC could not form a view that Telstra’s capital expenditure forecasts represent prudent and efficient expenditure.¹⁵⁶

3.2.3 NBN-specific capital expenditure

Telstra’s capital expenditure forecasts [c-i-c starts] [redacted]
[redacted]
[redacted]
[redacted]
[redacted]
[redacted] [c-i-c ends]

The ACCC considered it would be inappropriate to recover from fixed line access seekers or other users of the fixed line network costs of network investments which would not be required in the absence of the NBN roll out. If these investments were for the specific purpose of the NBN rollout and would not be required in the absence of the NBN, these costs should be recovered from NBN and not from other users of the fixed line network.¹⁵⁸

The ACCC also noted the inconsistency [c-i-c starts] [redacted]
[redacted]
[redacted]
[redacted]
[redacted] [c-i-c ends]

For the draft decision, the ACCC decided to exclude NBN-specific capital expenditure of [c-i-c starts] [redacted] [c-i-c ends] from the FLSM. The ACCC considered that this expenditure is incremental for the NBN roll out and should be recovered from the users of NBN (and not other users of the fixed line network).¹⁶⁰

3.2.4 Capital projects by IMC codes not relevant to fixed line services

Capital expenditure projects are grouped in Telstra’s database under program-specific codes known as IMC codes (IMC codes are codes identifying capital expenses in the general ledger). Within each IMC Code, capital expenditure is further broken down into individual asset codes which can be mapped to the asset categories used in the FLSM.

The ACCC noted the top 10 IMC-level projects in Telstra’s BBM RKR capital expenditure forecasts constitute a [c-i-c starts] [redacted] [c-i-c ends] proportion of the forecasts and was

¹⁵⁶ ACCC, Draft decision, March 2015, p. 76.

¹⁵⁷ Telstra, Appendix 4: *Forecast model v1.05 - Framework and guide to forecast assumptions*, October 2014, p. 61.

¹⁵⁸ ACCC, Draft decision, March 2015, p. 71.

¹⁵⁹ *ibid.*

¹⁶⁰ *ibid.*

concerned that certain projects from the BBM RKR forecasts do not appear to be incremental to the fixed line services.¹⁶¹

The ACCC considered that the methodology used by Telstra to forecast capital expenditure does not provide sufficient justification on the inclusion of certain IMC projects [c-i-c starts] [redacted] [c-i-c ends]. Thus, the ACCC could not form a view that Telstra’s capital expenditure forecasts represent prudent and efficient expenditure at this stage.

The ACCC’s draft decision was to not make further adjustment to capital expenditure forecasts for other IMC projects.¹⁶²

3.3 Telstra’s revised capital expenditure forecasts

The ACCC’s draft decision was based on information received from Telstra over a long period of time, up to 30 January 2015, including Telstra’s expenditure forecast submitted in January 2015.

Telstra provided revised forecasts in May 2015 with its draft decision submission. This was further to information provided in March 2015 regarding NBN-specific capital expenditure and IMC projects (discussed in sections 3.4.3 and 3.4.4 respectively). However, Telstra’s forecast of non-NBN capital expenditure in the May 2015 forecast remained unchanged from its forecast in January 2015, as discussed below.

In the May 2015 forecasts, Telstra forecasted [c-i-c starts] [redacted] [c-i-c ends] of capital expenditure for the period 2014–15 to 2018–19. The annual expenditure first [c-i-c starts] [redacted] [c-i-c ends] per annum over the remaining forecast period as indicated in the table below.

Table 3.1 Telstra’s January and May 2015 forecast capital expenditures (million, \$2009)

	2013–14	2014–15	2015–16	2016–17	2017–18	2018–19	Total (2014–15 to 2018–19)
Telstra January 2015 forecasts ^b	[c-i-c starts] [redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
ACCC draft decision ^a		[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Telstra May 2015 ^c proposal	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Annual change for May 2015 forecasts		[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[c-i-c ends]

[redacted]; a: nominal real dollar conversion is based on ACCC’s inflation estimate assumption for the March draft decision for comparison purposes; b: nominal real dollar conversion is based Telstra’s January 2015 inflation assumption for the purpose of determining its forecasts; c: nominal real dollar conversion is based Telstra’s May 2015 inflation assumption for the purpose of determining its forecasts

Telstra’s May 2015 capital expenditure forecasts were prepared using the same ‘bottom-up’ or ‘project level’ forecasting methodology as that used to prepare its January 2015 revised forecasts.¹⁶³

¹⁶¹ ACCC, Draft decision, March 2015, pp. 76–78.

¹⁶² *ibid*, pp. 77–78.

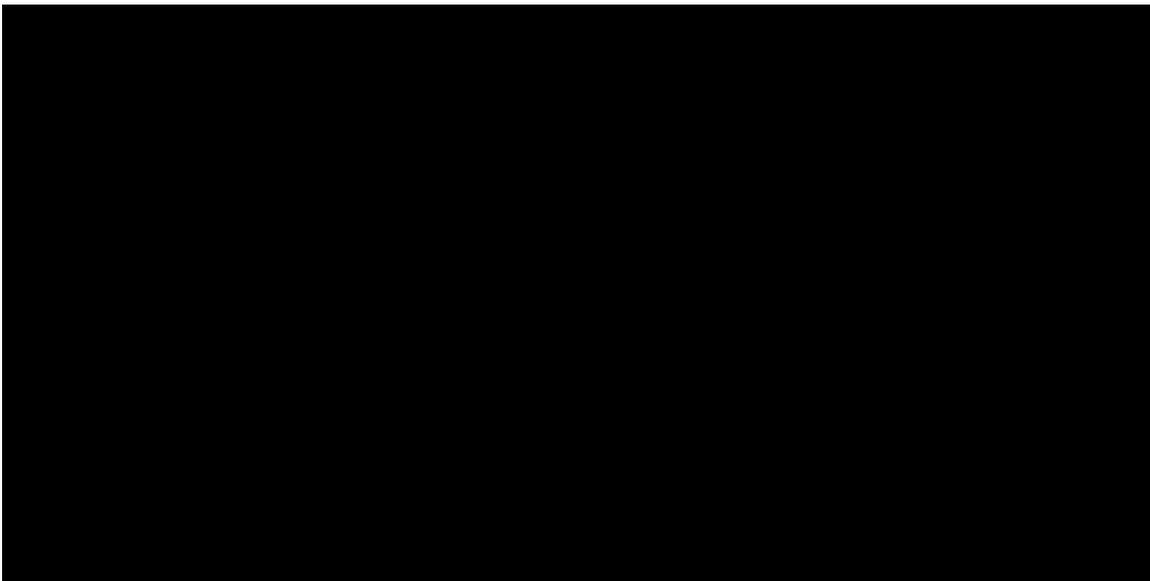
Telstra's methodology used a 'bottom up' approach to identify capital expenditure related to FLSM asset classes to establish a base year cost which then uses various trends (e.g. moving linear trend and NBN scale-down) to forecast capital expenditure for the next regulatory period. Specifically, [c-i-c starts] [redacted]

[redacted]
[redacted]
[redacted]
[redacted] [c-i-c ends].

The difference between the January 2015 and May 2015 capital expenditure forecasts can be mainly attributed to Telstra reducing forecast NBN-specific capital expenditure (from [c-i-c starts] [redacted] [c-i-c ends] million in the January 2015 forecasts to [c-i-c starts] [redacted] [c-i-c ends] million in May 2015).¹⁶⁴ Telstra has explained that the reduction is due to revising down the cost of NBN-specific network remediation expenditure from [c-i-c starts] [redacted] [c-i-c ends] to [c-i-c starts] [redacted] [c-i-c ends] per premises. Telstra submitted that this is due to reappraisals' of Telstra's responsibilities in relation to its agreements with NBN.¹⁶⁵

The ACCC notes that Telstra's May 2015 forecasts is [c-i-c starts] [redacted] [c-i-c ends] the January 2015 forecasts over the period 2014–15 to 2018–19 as indicated in the figure below.

Figure 3.1: Comparison of Telstra's January 2015 and May 2015 forecasts [c-i-c starts]



[redacted] [c-i-c ends]

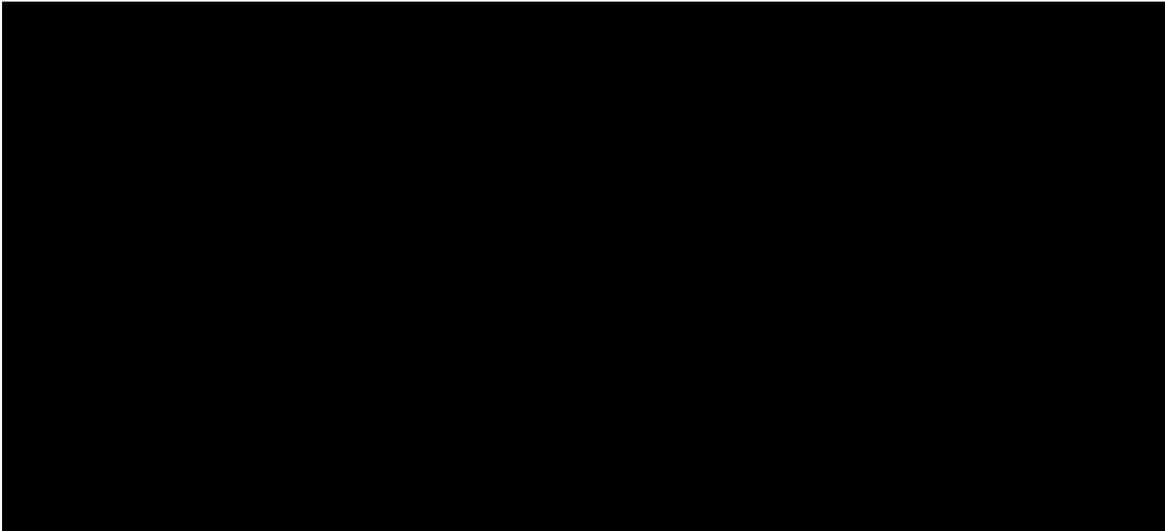
The ACCC makes the following observations on the May 2015 capital expenditure forecasts (based on the base case NBN rollout in Telstra's forecast model): [c-i-c starts]

- [redacted]

¹⁶³ Telstra, *Response to Draft Decision: Public inquiry into final access determinations for fixed line services – primary services (main submission), confidential version*, 1 May 2015, p. 22.
¹⁶⁴ Telstra, Main submission to the draft decision, p. 143. Telstra submitted that certain NBN-related work remediation cost forecast to be incurred by Telstra in the 2014 forecasts had been incorrectly interpreted as capital expenditure.
¹⁶⁵ Telstra, Main submission to the draft decision, pp. 26 & 143.

- [redacted]
[redacted]
[redacted]
[redacted]
- [redacted]
[redacted]
[redacted]
[redacted] [c-i-c ends]

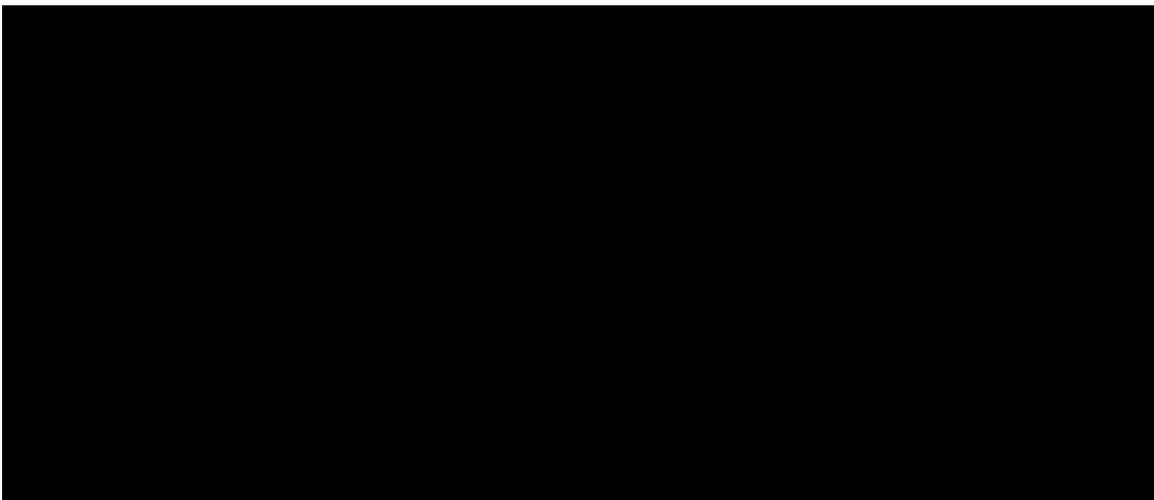
Figure 3.2: Telstra’s actual and May 2015 capital expenditure forecasts [c-i-c starts]



[redacted] [c-i-c ends]

- Telstra provided the forecasts in terms of the four main drivers of capital expenditure: ‘demand’, ‘AROS’, ‘discretionary’ and ‘NBN remediation’. Demand [c-i-c starts]
[redacted]
[redacted] [c-i-c ends] of total expenditure due to [c-i-c starts] [redacted]
[redacted] [c-i-c ends].

Figure 3.3: Telstra’s capital expenditure forecast by cost drivers [c-i-c starts]



[redacted] [redacted] [c-i-c ends]

3.4 Submissions

This section contains key submissions on the four main issues identified in the draft decision.

3.4.1 Methodology for forecasting capital expenditure

In its submission to the draft decision, Telstra stated that the methodology for forecasting FLSM relevant capital expenditure is 'reasonable and appropriate by combining relevant historic trends with project and asset-specific capital expenditure planning information'.¹⁶⁶

Telstra stated that it did not forecast investment at an asset level.¹⁶⁷ Telstra's consultant, Sapere Research Group stated that Telstra did not provide detailed physical asset information because this information would be very detailed, complex and costly to prepare.¹⁶⁸

Telstra also submitted that its network is 'too extensive and complex to project the investment demands for individual assets or types of assets over a four year period'. Telstra further noted it 'does not in the ordinary course of its business planning seek to quantify capital expenditure on the basis of physical units'.¹⁶⁹ Telstra stated that it would be impractical to adopt a physical-based forecasting model, given that it would require the development of information that is not routinely recorded or systematically stored by Telstra.¹⁷⁰

Telstra provided additional evidence to demonstrate its capital expenditure forecast is conservative, which includes:

- Telstra has 'set aside' almost [c-i-c starts] [redacted] [c-i-c ends] (in nominal dollar terms) in past capital expenditure attributable to the FLSM Asset Classes on the basis that the programs under which this expenditure is incurred are not expected to continue past 2013–14. This has led to a reduction of [c-i-c starts] [redacted] [c-i-c ends] in capital expenditure on the FLSM Asset Classes for the 2014–15 to 2018–19 in nominal terms.¹⁷¹
- Telstra has limited some capital expenditure to a [c-i-c starts] [redacted] [c-i-c ends]. Absent this adjustment, forecast capital expenditure for 2015–16 to 2018–19 would be [c-i-c starts] [redacted] [c-i-c ends] higher in nominal terms'.¹⁷²
- Based on Telstra's recent capital planning round for 2015–16, Telstra's budget for capital expenditure on the FLSM Asset Classes for that year will exceed the FLSM forecasts by more than [c-i-c starts] [redacted] [c-i-c ends] (in nominal dollar terms). The need for this capital expenditure increase reflects delays in the rollout of the NBN and unexpectedly strong growth in new estates and residential developments.¹⁷³
- Telstra's 2014–15 capital budgets (after updating for part-year actuals) is similar to the FLSM forecast for that year.¹⁷⁴

Frontier Economics (Frontier), on behalf of the Competitive Carriers' Coalition (CCC), Optus and iiNet, submitted that the ACCC cannot be 'satisfied as to the prudence and efficiency of Telstra's forecast expenditures'.¹⁷⁵ Frontier agreed broadly with the base step trend approach

¹⁶⁶ Telstra, Main submission to the draft decision, pp. 10, 22.

¹⁶⁷ *ibid.*, pp. 129–130.

¹⁶⁸ *ibid.*

¹⁶⁹ *ibid.*

¹⁷⁰ *ibid.*

¹⁷¹ *ibid.*, pp. 10, 23, 127.

¹⁷² *ibid.*, p.127.

¹⁷³ *ibid.*, pp. 25, 127.

¹⁷⁴ *ibid.*, pp. 140–141.

¹⁷⁵ Frontier, *Submission on the ACCC's draft decision on fixed line prices – a reported prepared for the competitive carriers coalition, iiNet and Optus*, confidential version, May 2015, p. 3.

but noted that ‘the information provided by Telstra to support its base level of expenditure and the future rate of change in costs is not reliable’.¹⁷⁶

Frontier submitted that ‘it would be inappropriate for the ACCC to accept Telstra’s base year expenditure...because Telstra has...provided insufficient information to assess the prudence and efficiency of those costs’. In addition, Frontier noted that, unless Telstra’s base level expenditure is efficient and prudent, the ACCC ‘risks entrenching inefficiently high access prices’.¹⁷⁷

Frontier noted that ‘it is highly desirable that the ACCC develop its own...estimate of base year expenditure’.¹⁷⁸ Frontier suggested two possible options:¹⁷⁹

- ‘commission a detailed engineering and economic assessment of Telstra’s network to form [a] view on the prudent and efficient level of costs in the base year’, or
- ‘understand...the most important characteristics or features of the network’ and then ‘estimate the cost associated with operating a network with those features’. Frontier acknowledged that this is ‘unlikely to be possible within the ACCC’s timetable’, but noted that ‘it would be more desirable for the ACCC to take the time necessary to make a better assessment of base year expenditure than to maintain the approach...in the draft decision’.

Frontier stated that several of WIK’s recommendations can be implemented for determining the rate of change for the forecasts.¹⁸⁰

Frontier noted that Telstra’s approach of allocation capital expenditure to FLSM asset classes ‘appears to allow it...discretion to allocate more costs to asset classes that involve less sharing with non-regulated services (and so result in relatively higher FLS services)’.¹⁸¹ Frontier supported WIK’s recommendations for ‘a...more rigorous set of relationships between cost centres’ and capex. However, Frontier acknowledged that this would involve ‘considerable work’ which provides ‘further support for taking a...top down approach to cost forecasting’.¹⁸²

Frontier suggested that if the ACCC wishes to make a decision by June 2015, it ‘should seek further information from Telstra on the base year costs’ to establish a base year capital expenditure and then forecast aggregate capital expenditure forward in proportion to the changes in SIOs due to the NBN rollout.¹⁸³ Frontier noted that this top-down approach has a number of benefits: ‘obviate the need to make a detailed bottom-up assessment of changes in Telstra’s costs’, reflect that ‘the copper network is in a declining phase’ and ‘more consistent with the ACCC’s previous approach in 2011’. Frontier has also modelled this option [c-i-c starts]

[redacted] [c-i-c ends].¹⁸⁴

Optus submitted that the ACCC should not ‘accept Telstra’s forecast...in the current form’.¹⁸⁵ Optus noted the following for Telstra’s methodology:

- there is a ‘lack of transparency...between the cost driver volumes and the level of capital expenditure’¹⁸⁶ and the ‘forecast cannot be verified’ due to the ‘absence of...cost volume relationships’.¹⁸⁷

¹⁷⁶ Frontier, Submission to the draft decision, p. 11.

¹⁷⁷ *ibid.*, pp. 11–12.

¹⁷⁸ *ibid.*, p. 12.

¹⁷⁹ *ibid.*, p. 13.

¹⁸⁰ *ibid.*, p. 14.

¹⁸¹ *ibid.*, p. 20.

¹⁸² *ibid.*, p. 21.

¹⁸³ *ibid.*, pp. 27–28.

¹⁸⁴ *ibid.*, pp. 29–30.

¹⁸⁵ Optus, *Submission in response to ACCC draft decision – Public inquiry into final access determinations for fixed line services – primary price terms*, confidential version, April 2015, p. 39.

¹⁸⁶ *ibid.*, p. 40.

¹⁸⁷ *ibid.*

- ‘Telstra has provided little...justification that its expenditure is efficient and prudent, and has failed to provide sufficient evidence to identify the appropriate cost causal relationships’.¹⁸⁸

Optus noted the following issue with the methodology for demand-related and AROS capital expenditure:¹⁸⁹ [c-i-c starts]

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

- [redacted] [c-i-c ends]
- ‘It is unclear on what basis the current trend analysis approach is preferred over other alternatives for each asset class.’¹⁹⁰ Optus [recommended] that the ‘reasonableness of using a linear extrapolation for forecasting capex should be reviewed’ given the significant variations that can result from the choice of trend applied, as well as the variations of trends applied to different asset classes.

Optus stated that ‘on the evidence before it, the ACCC cannot...assess Telstra’s proposal as efficient and prudent’ and ‘should therefore...reject Telstra’s forecasts’.¹⁹¹

Optus noted that ‘allowing these forecasts in the FLSM is not consistent with the legislative criteria, the fixed principles or the approach adopted in other industries that rely on RAB forecasts’.¹⁹² Optus suggested that the ACCC should adopt the AER’s process for expenditure forecasts (i.e. use its own forecasts when differences with the regulated business’ forecasts cannot be explained in a satisfactory manner).¹⁹³

iiNet submitted that the consideration of Telstra’s expenditure forecasts used for the draft decision needs to take place in the contexts of the fixed principles provisions, Telstra’s incentive to distort inputs to the FLSM and the ACCC’s draft decision not reaching a conclusion on the efficiency and prudence of expenditure inputs.¹⁹⁴ iiNet submitted that ‘more drastic action of the kind recommended by [Frontier Economics on Telstra’s forecasts] is required’.

3.4.2 Demand-related capital expenditure

Telstra submitted that its transmission capital expenditure forecast is ‘efficient and prudent and materially below the observed trend of increasing expenditure’.¹⁹⁵ Telstra stated that it has ‘capped’ capital expenditure growth for transmission assets to a [c-i-c starts] [redacted] [c-i-c ends] to demonstrate the ‘prudence and conservatism of [its] approach’. Telstra noted that its approach reduces transmission capital expenditure by [c-i-c starts] [redacted] [c-i-c ends] (in nominal terms) relative to an unconstrained estimate over 2014–15 to 2018–19.¹⁹⁶

¹⁸⁸ Optus, Submission to the draft decision, p. 45.

¹⁸⁹ *ibid.*, pp. 47–50.

¹⁹⁰ *ibid.*, p. 48.

¹⁹¹ *ibid.*, p. 55.

¹⁹² *ibid.*

¹⁹³ *ibid.*, pp. 37 & 55.

¹⁹⁴ iiNet, Public inquiry into final access determinations for fixed line services – primary price terms – draft decision March 2015 – Submission to the draft decision, May 015, p. 5.

¹⁹⁵ Telstra, Main submission to the draft decision, p. 137.

¹⁹⁶ *ibid.*

• [redacted]

[redacted]

• [c-i-c starts] [redacted]

[redacted]

[redacted] [c-i-c ends]

3.4.3.2 Telstra’s submission to the draft decision

Telstra submitted that a ‘consistent application of the Fixed Principles and a fully allocated pricing framework requires [NBN-specific expenditure] to be included in the FLSM’ as it is ‘directly associated with FLSM asset classes’.²⁰⁶

Telstra noted that ‘all services that make use of Telstra’s duct network...benefit from the NBN duct remediation program’ and ‘it is...incorrect to assume that once the NBN is established in an area that all other services will cease to make of the duct network’.²⁰⁷ Telstra submitted that ‘the cost of remediation of the shared asset should be borne by all services that will make use of it over the forecast period’.

[c-i-c starts] [redacted] [c-i-c ends] Telstra has not provided an explanation on the movement of this capital expenditure.

Frontier submitted that ‘the ACCC should not allow charges to rise due to loss of (NBN related) economies of scale’ because ‘the NBN migration is a voluntary action by Telstra’ and ‘access seekers are not responsible for the migration and derive no direct benefits from the NBN Co agreements’.²⁰⁸

Optus submitted that ‘NBN-related capex should not be included in the FLSM’.²⁰⁹ Optus stated that ‘the ACCC is...correct in its draft decision to exclude NBN-specific capex from the FLSM, on the basis that this expenditure is incremental for the NBN rollout and should be recovered from the users of NBN Co’. Optus also submitted that Telstra [c-i-c starts] [redacted] [c-i-c ends].²¹⁰

²⁰⁵ Telstra, Fixed line services final access determination inquiry: ACCC request for information, 5 March 2015, p. 4. In its revised forecast for capital expenditure, Telstra has revised down the cost of NBN-related network remediation expenditure from [c-i-c starts] [redacted] [c-i-c ends] per premises, as discussed in the further draft decision section.

²⁰⁶ Telstra, Main submission to the draft decision, p. 25.

²⁰⁷ *ibid.*, pp. 25–26.

²⁰⁸ Frontier, Main submission to the draft decision, p. 14.

²⁰⁹ Optus, Submission to the draft decision, pp. 52–54.

²¹⁰ *ibid.*, p. 52.

3.4.4 Capital projects by IMC codes

3.4.4.1 Telstra's March 2015 response

In response to the ACCC's 12 February 2015 information request,²¹¹ Telstra submitted version 1.2 of its FLSM ('FLSM FY2015–FY2019 v1.2'), documentation for differences with version 1.1 and further documentation for its 2013–14 operating expenditure in March 2015.

As part of its submission, Telstra also provided [c-i-c start]

[c-i-c end].

The ACCC notes that Telstra has previously provided its top 10 IMCs in February 2014 (for the BBM RKR forecasts) for 2013-14. In January 2015, Telstra revised the IMC information to update its top 10 IMC-level projects for 2014–15.²¹³

3.4.4.2 Telstra's submission to the draft decision

Telstra noted that the name of IMC codes does not necessarily reflect accurately or completely the nature of the work within the IMC codes.²¹⁴

Telstra stated that it has 'adopted a conservative approach to the inclusion of IMC-level expenditure in its capital expenditure forecasts' which is likely to have excluded IMC-level projects that relates to FLSM assets.²¹⁵

Telstra provided further explanation on how IMC information was incorporated into FLSM capital expenditure forecasts in its submission to the draft decision,²¹⁶ specifically:²¹⁷

- Telstra includes IMC codes that are related to the FLSM asset classes. The capital expenditure within IMC Codes is 'sorted according to the asset classes against which expenditure is incurred to exclude capital on non-FLSM assets from the total of FLSM-relevant IMC codes'.
- For asset classes which are wholly attributable to a FLSM asset category, Telstra allocate all forecast capital expenditure attributable to that asset class to the relevant FLSM category.
- Where those asset classes are not wholly related to the provision of fixed line services, the classes are broken down further to assess which assets are properly attributable to the provision of fixed line services.
- Telstra also excludes 'a range of projects' for reasons such as they are 'due to end during FY14 or FY15' or 'relatively small projects where these have a highly volatile...expenditure profile'.

In relation to only providing IMC level information for 2014–15, Telstra also submitted [c-i-c starts]

[c-i-c ends].²¹⁸

²¹¹ ACCC, ACCC's fixed line services access determination inquiry: request for further Information, 12 February 2015.

²¹² Telstra, Public inquiry into final access determinations for fixed line services–primary prices (confidential version), 12 March 2015.

²¹³ ACCC, Draft decision, pp. 77–78.

²¹⁴ Telstra, Main submissions to the draft decision, pp. 132–133.

²¹⁵ *ibid.*

²¹⁶ *ibid.*, pp. 131–132.

²¹⁷ *ibid.*, pp. 131–133.

reflects removal of [c-i-c starts] [REDACTED] [c-i-c ends] being Telstra’s revised NBN-specific capital expenditure.

Table 3.2 Telstra’s forecast capital expenditure and ACCC further draft decision (million, \$2009)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Telstra January 2015 forecasts ^a	[c-i-c starts] [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
ACCC draft decision ^b	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Telstra May 2015 forecasts ^a	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
ACCC further draft decision ^c	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED] [c-i-c ends]

[REDACTED] a: nominal real \$ conversion is based on Telstra’s inflation assumption for the purpose of determining its forecasts; b: nominal real \$ conversion is based on ACCC’s inflation for the March draft decision; c: The nominal capital expenditure amount in the ACCC’s further draft decision remains unchanged from the draft decision. The difference in real \$ amount from the draft decision is due to an updated inflation adopted for the further draft decision.

Reasons for the ACCC further draft decision on outstanding issues regarding capital expenditure are set out in this section.

3.5.1 Methodology for forecasting capital expenditure

In its draft decision, the ACCC considered that Telstra’s proposed capital expenditure forecast methodology does not provide sufficient evidence on the linkage between cost drivers and the forecasts. Thus, the ACCC was unable to form a view on the reasonableness of Telstra’s capital expenditure forecast methodology based on the information available to it.

3.5.1.1 Assessment

The ACCC is of the view that an appropriate forecast of capital expenditure would be based on a forecast of cost driver volumes (i.e. demand for fixed line services and asset quantities) and a functional relationship between the cost-driver volume and the amount of capital expenditure. The ACCC notes Optus’ submission that Telstra has provided some information for the efficiency and prudence of the capital expenditure,²²⁶ but has ‘failed to provide sufficient evidence to identify the appropriate cost causal relationships’.²²⁷

However, the ACCC notes the submissions from Telstra and its consultant in terms of the practical difficulty in forecasting investment at an asset level. Telstra has submitted that its forecasts are conservative and is based on adopting certain assumptions when applying a linear trend analysis to historical data.²²⁸

- ‘capping’ growth for certain expenditure – Telstra has limited some capital expenditure to [c-i-c starts] [REDACTED] [c-i-c ends]. Forecast capital expenditure across the FLSM asset classes for 2014–15 to 2018–19 would be [c-i-c starts] [REDACTED] [c-i-c ends] higher in nominal terms’ relative to an unconstrained estimate.

²²⁶ Optus, Submission to the draft decision, pp. 39–44.

²²⁷ *ibid*, pp. 45 & 50.

²²⁸ Telstra, Main submissions to the draft decision, pp. 24, 127–130.

- excluding capital projects that are not ongoing– Telstra has ‘set aside’ almost [c-i-c starts] [c-i-c ends] (in nominal dollar terms) in past capital expenditure attributable to the FLSM Asset Classes on the basis that the programs under which this expenditure is incurred are not expected to continue past 2013–14. This has led to a reduction of [c-i-c starts] [c-i-c ends] capital expenditure on the FLSM Asset Classes for the 2014–15 to 2018–19 in nominal terms.

The ACCC agrees that it would not be prudent to include forecasted capital expenditure based on past expenditure that is not ongoing. That said, the ACCC considers these assumptions reasonable as together they reduce the capital expenditure forecasts by [c-i-c starts] [c-i-c ends] (in nominal terms) for the period from 2014–15 to 2018–19.²²⁹

The ACCC also notes Telstra’s statement that its forecast methodology ‘does not rely simply on historic or linear trends, but overlays a series of adjustments that reflect conservative (prudent) assumptions regarding forecast capital expenditure.’²³⁰ Specifically, Telstra has capped the growth of certain capital expenditure (as noted above) and scaled down capital expenditure for assets most likely to be impacted by the NBN. The ACCC considers that it is reasonable and prudent to reduce capital expenditure for the impact of the NBN rollout given declining demand for fixed line services over Telstra’s network and the forthcoming migration to the NBN.

The ACCC has considered the proposal by Frontier and Optus requesting the ACCC to determine its own capital expenditure forecast. In response, the ACCC has analysed alternative approaches to forecast Telstra’s capital expenditure. The analysis involved scaling down capital expenditure in line with the NBN rollout using two base level starting scenarios:

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

The alternative capital expenditure forecasts (after excluding NBN-specific capital expenditure) are provided in the table below:

Table 3.3: Telstra’s capital expenditure forecasts and alternative ACCC forecasts for 2014–15 to 2018–19, after excluding NBN-specific capital expenditure (\$2009, \$million)

	Pre–NBN rollout scale down ²³¹	After NBN rollout scale down
Telstra May 2015 forecasts ^a	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]
ACCC forecast (2014-15 base) ^a	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]
ACCC forecast (4 year average for 2011–12 to 2014–15) ^a	[c-i-c starts] [c-i-c ends]	[c-i-c starts] [c-i-c ends]

Source: ACCC analysis; ^aBased on the ACCC’s updated inflation assumptions for the May further draft decision.

The ACCC notes the following regarding the analysis from Table 3.3:

- Pre–NBN rollout adjustment, Telstra’s forecast methodology results in a forecast capital expenditure [c-i-c starts] [c-i-c ends] for the period 2014–15 to

²²⁹ Telstra, Main submission to the draft decision, pp. 136 & 138.

²³⁰ *ibid.*, p. 129.

²³¹ [c-i-c starts] [c-i-c ends]
[c-i-c starts] [c-i-c ends]
[c-i-c starts] [c-i-c ends]
[c-i-c starts] [c-i-c ends]

2018–19 that is less than the alternative forecasts of [c-i-c starts] [redacted] [c-i-c ends].

- After the NBN rollout adjustment, the alternative forecasts result in [c-i-c starts] [redacted] [c-i-c ends] for the period 2014–15 to 2018–19. These could be interpreted as possible upper and lower bounds for Telstra’s capital expenditure forecast that has excluded NBN specific costs. Telstra’s methodology results in a forecast capital expenditure [c-i-c starts] [redacted] [c-i-c ends], after removing NBN costs, that is within the ACCC’s forecast range.

The ACCC notes that the draft decision for capital expenditure resulted in [c-i-c starts] [redacted] [c-i-c ends] for the period 2014–15 to 2018–19). For the further draft decision, the ACCC forecasts capital expenditure of [c-i-c starts] [redacted] [c-i-c ends] for the period 2014–15 to 2018–19 which results in [c-i-c starts] [redacted] [c-i-c ends] for the period as the draft decision and Frontier’s submission.

3.5.1.2 Further draft decision

The ACCC notes that, despite the further information that Telstra has provided on its forecast methodology, there remain limitations regarding the information provided on the linkage between cost drivers and the forecasts. However, the ACCC notes that Telstra has ‘capped’ the growth of certain capital expenditure [c-i-c starts] [redacted] [c-i-c ends] and ensured that the forecast methodology does not include non-ongoing expenditure. This limits forecast capital expenditure, given the declining demand for fixed line services provided over the Telstra’s network, and also provides some growth in users’ capacity (for data traffic in particular).²³²

The ACCC considers the access seekers’ proposal to substitute Telstra’s forecast with the ACCC’s forecast provides a useful cross-check for assessing Telstra’s forecasts. In light of that analysis, the ACCC considers that Telstra’s forecast methodology appears to be reasonable for the following reasons:

- Once NBN capital expenditure is removed, the capital expenditure forecast is: (i) below the ACCC’s alternative forecasts pre–NBN rollout adjustment, and (ii) within the range of the ACCC’s alternative forecasts after the NBN roll-out adjustment.
- Telstra has made certain methodological assumptions to improve the reasonableness of its capital expenditure forecasts.

Consequently, although the ACCC previously had some concerns on the forecast methodology, it considers that Telstra has endeavoured to provide justification and information regarding the level of transparency in relation to capital expenditure forecasts. The ACCC also notes Telstra’s practical difficulty in forecasting capital expenditure at an asset level, and a reasonable expenditure forecast outcome.

Therefore, for the purpose of this further draft decision, the ACCC accepts Telstra’s methodology for forecasting capital expenditure.

²³² ABS, 8153.0–Internet Activity Survey Australia, December 2014, volume of data downloaded by access connections, available at: <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8153.0Main+Features1December%202014?OpenDocument>; ABC, <http://www.abc.net.au/news/2013-05-31/internet-traffic-to-triple-in-four-years/4725126>; <http://www.nbnco.com.au/corporate-information/media-centre/media-releases/aussie-ifamilies-hungry-for-fast-broadband.html>; http://www.arnnet.com.au/article/463349/ip_traffic_2017_alone_may_larger_than_all_internet_history_cisco Broughton, Kenny, *Domestic bandwidth requirements in Australia–A forecast for the period 2013–2023*, 26 May 2014

3.5.2 Demand-related capital expenditure

Telstra's capital expenditure forecasts group expenditure into four main drivers: demand, asset replacement and operational support (AROS), discretionary and NBN. Under each driver, capital expenditure forecasts are further grouped by FLSM asset classes. Telstra's demand-related capital expenditure is the [c-i-c starts] [redacted] [c-i-c ends] of capital expenditure over the forecast period.

The ACCC noted in its draft decision that the demand-related capital expenditure forecast for transmission equipment when taken with Telstra's cost allocation framework (CAF) would allocate [c-i-c starts] [redacted] [c-i-c ends]. The ACCC considered that, for transmission equipment, [c-i-c starts] [redacted] [c-i-c ends].

In the draft decision, the ACCC considered that Telstra's methodology for forecasting capital expenditure did not provide sufficient evidence on the linkage between demand-related capital expenditure forecast for transmission assets and [c-i-c starts] [redacted] [c-i-c ends] to the declared fixed line services.

Assessment and further draft decision

In considering demand-driven capital expenditure for transmission assets, the ACCC notes that it is likely to continue during and beyond the NBN rollout. This is because there is growing demand for data transmission capacity and transmission assets are likely to service end-users on the NBN and Telstra's fixed line network.

The ACCC notes Telstra's statement on the reasonableness of its forecasts which have reduced transmission capital expenditure by [c-i-c starts] [redacted] [c-i-c ends] million in nominal terms below Telstra's January 2015 forecasts on which the draft decision was based. This reduction is a result of Telstra 'capping' [c-i-c starts] [redacted] [c-i-c ends].²³³

The ACCC remains concerned that Telstra's demand-related capital expenditure forecast for transmission assets are not derived from cost drivers. However, the ACCC notes these changes to Telstra's demand-driven capital expenditure forecast for transmission equipment result in relatively [c-i-c starts] [redacted] [c-i-c ends] forecasts for the period 2015–16 to 2018–19 despite recent and prospective growth in data traffic.²³⁴

- the amount of data traffic used by Australians has increased at an average annual rate of 56 per cent since December 2009
- data traffic is likely to continue growing (e.g. due to increasing usage of data-intensive applications).²³⁵

The ACCC notes Frontier's submission to remove all demand-driven capital expenditure for transmission assets. However, as noted above, transmission assets are likely to service end-

²³³ Telstra, Main submissions to the draft decision, p. 137.

²³⁴ ABS, 8153.0—Internet Activity Survey Australia, December 2014, volume of data downloaded by access connections, available at: <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8153.0Main+Features1December%202014?OpenDocument>

²³⁵ ABC, <http://www.abc.net.au/news/2013-05-31/internet-traffic-to-triple-in-four-years/4725126> ; <http://www.nbnco.com.au/corporate-information/media-centre/media-releases/aussie-ifamilies-hungry-for-fast-broadband.html>; http://www.arnnet.com.au/article/463349/ip_traffic_2017_alone_may_larger_than_all_internet_history_cisco Broughton, Kenny, *Domestic bandwidth requirements in Australia—A forecast for the period 2013–2023*, 26 May 2014

users on both the NBN and Telstra’s fixed line network and the anticipated growth in data traffic would likely result in continued investment in these assets.

The ACCC considers that Telstra’s capital expenditure forecast demand-related transmission capital does not appear to be unreasonable as Telstra forecasts relatively [c-i-c starts] [redacted] [c-i-c ends] over the forecast period (2015–16 to 2018–19) despite recent and prospective growth in data traffic.

The ACCC also considers that Telstra, as part of its forecast methodology, made adjustments (i.e. limiting the forecast transmission capital expenditure) on the reasonableness of demand-driven capital expenditure for transmission assets.

The ACCC also notes that its consultant Analysys Mason has endorsed Telstra’s platform allocators for the transmission technologies. This is discussed in more detail in the cost allocation chapter.

Therefore, the ACCC’s further draft decision is to not adjust forecast capital expenditure for transmission equipment on the basis that Telstra’s methodology has produced a reasonable capital expenditure forecast.

3.5.3 NBN specific capital expenditure

In the draft decision, the ACCC excluded NBN-specific capital expenditure of [c-i-c starts] [redacted] [c-i-c ends] million (\$2009) from the FLSM, on the basis that this expenditure is incremental for the NBN roll out and should be recovered from the users of NBN (and not other users of the fixed line network).²³⁶

Assessment and further draft decision

The ACCC notes that Telstra continues to submit that, as NBN related capital expenditure is directly associated with FLSM asset classes, it should be included in the FLSM for a consistent application of the Fixed Principles and a fully allocated pricing framework.²³⁷

However, the ACCC notes that Telstra has revised down its NBN-specific network remediation expenditure from [c-i-c starts] [redacted] [c-i-c ends] [redacted] (\$2009) to [c-i-c starts] [redacted] [c-i-c ends] [redacted] as a result of revising down the cost of NBN-specific network remediation expenditure from [c-i-c starts] [redacted] [c-i-c ends] to [c-i-c starts] [redacted] [c-i-c ends] per premises. Telstra submitted that this is due to ‘reappraisals’ of Telstra’s responsibilities in relation to its agreements with NBN.²³⁸

The ACCC considers that NBN-specific expenditure is incremental to the NBN because those costs are attributable to the NBN. Therefore they should be separated from FLSM costs and separately recovered from the NBN and its users, rather than from other users of Telstra’s fixed line network.

The ACCC notes Telstra’s submission also supports the ACCC’s view that the NBN-specific expenditure is incremental to the NBN:²³⁹ [c-i-c starts]

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

²³⁶ ACCC, Draft decision, p. 73.

²³⁷ Telstra, Main submissions to the draft decision, p. 25.

²³⁸ *ibid.*, p. 143.

²³⁹ Telstra, Fixed line services final access determination inquiry: ACCC request for information, 5 March 2015, p. 3.

• [redacted] [c-i-c ends]

The ACCC notes comments by Frontier for the exclusion of capital expenditure incremental to NBN's demand for fixed line assets²⁴⁰ and support for removing this capital expenditure from the FLSM as they are 'clearly incremental to NBN's usage of the network'.²⁴¹ Optus also supported the decision to remove NBN-specific capital expenditure: 'the ACCC is...correct in its draft decision to exclude NBN-specific capex from the FLSM, on the basis that this expenditure is incremental for the NBN rollout and should be recovered from the users of NBN'.²⁴²

The ACCC notes that where costs can be identified as directly attributable to a particular use, the fixed principles provisions require that the costs be allocated to that use. In the absence of new evidence from Telstra, the ACCC maintains its draft decision that NBN-specific capital expenditure is incremental to the NBN and should be recovered from NBN and its users (and not other users of the fixed line network). Additionally, the ACCC notes that a similar principle applies to 'Telstra Wholesale' operating expenditure, which is directly recovered from the regulated fixed line services because they can be directly attributed to those services.

Therefore, the ACCC's further draft decision is to exclude [c-i-c starts] [redacted] [c-i-c ends] million NBN-specific capital expenditure from the FLSM.

3.5.4 Capital projects by IMC codes

Telstra's capital expenditure is grouped at a project level by IMC codes. In the draft decision, the ACCC raised concerns that certain IMC codes [c-i-c starts] [redacted] [c-i-c ends] cover activities that may not directly relate to the declared fixed line services and/or skew capital costs to a specific asset class. The ACCC also raised concerns with Telstra's provision of top IMC codes for 2014–15 but not for subsequent years (2015–16 to 2018–19).²⁴³

Assessment and further draft decision

The ACCC notes Telstra's submission that the name of the IMC codes does not necessarily outline the full scope of activities undertaken for certain projects or if they are related to the declared fixed line services. However, the ACCC considers that it appears reasonable for Telstra to include capital expenditure forecasts for certain IMC codes [c-i-c starts] [redacted] [c-i-c ends] given the following:

- Telstra's further evidence indicates that they are related to the provision of services using assets in the fixed line network, and
- They are not related to NBN-specific capital expenditure.

As an example, Telstra noted that that when providing fibre services for retail customers and mobile base stations, expenditure also occurs on the FLSM asset classes (e.g. ducts, cables, etc.) to 'meet [all requirements] and 'optimise investment'.²⁴⁴ [c-i-c starts] [redacted]

²⁴⁰ Frontier, Main submission to the draft decision, p. 20.

²⁴¹ Frontier, Assessment of Telstra's revised forecasts, December 2014, pp. 13–14.

²⁴² Optus, Submission to the draft decision, pp. 52–54.

²⁴³ ACCC, Draft decision, p. 77.

²⁴⁴ As an example, Telstra submitted that when providing fibre services for retail customers and mobile base stations, Telstra will also consider other demand and AROS requirement in the area to optimise the investment. Therefore assets such as ducts, copper cables and transmission equipment will be installed with sufficient capacity to meet all requirements including the fixed line services. As a result, expenditure occurs on the FLSM asset classes when providing services for retail customers and mobile base stations. Telstra, main submissions to the draft decision, p. 132.

[c-i-c ends]

The ACCC notes that Telstra has provided additional information on the process of mapping of capital expenditure to FLSM asset classes, which further indicates that capital expenditure for each of these IMC Codes can be traced through to asset classes used to provision fixed line services.²⁴⁶ Telstra has also submitted that '[capital expenditure related to the FLSM asset classes] within the IMC [codes] is sorted according to the asset classes against which expenditure is incurred'.²⁴⁷

In response to the concern raised in the draft decision that Telstra [c-i-c starts]

[c-i-c ends]

Telstra submitted that it does not forecast capital expenditure on specific projects more than one year ahead. Telstra added that to forecast five years of capital expenditure at the asset class level as required under the FLSM, it had to adopt the current 'approach for the forecast period' which is based on trends in historical expenditure for the FLSM asset classes under the relevant IMC codes'.

The ACCC considers that in its responses and submissions since February 2015, Telstra has provided sufficient explanation and information for the relevance, prudence and efficiency of capital expenditure relevant to the FLSM in terms of IMC projects. The ACCC considers that it is reasonable for Telstra to include certain IMC codes (e.g. [c-i-c starts]

[c-i-c ends])

- Telstra's further evidence indicates that they are related to the provision of services using assets in the fixed line network and not related to NBN-specific capital expenditure
- Telstra has provided further information which indicates that capital expenditure for these IMC codes can be traced to the FLSM asset classes.

Therefore, the ACCC's further draft decision is that the inclusion of these IMC codes in the capital expenditure forecasts is prudent and efficient and to not make further adjustments to capital expenditure forecasts on the basis of IMC codes.

²⁴⁵ Telstra, Fixed line services final access determination inquiry: ACCC request for information, 30 January 2015, p. 8.

²⁴⁶ Telstra, Main submissions to the draft decision, p. 133.

²⁴⁷ *ibid.* The ACCC notes that Telstra has provided capital expenditure for each of the top 10 IMC programs by FLSM asset classes for 2013–14 and 2014–15.

4 Impacts of the National Broadband Network

Key Points

- The arrangements between Telstra and NBN in relation to the migration of fixed line customers to the NBN are formalised under the Definitive Agreements (DAs). Under these arrangements, Telstra will receive payment when a retail or wholesale customer is disconnected from its fixed line network and migrated to the NBN. Further, Telstra has undertaken not to compete with NBN in the fixed line market where the NBN is deployed.
- These arrangements will result in a loss of economies of scale in the operation of Telstra's fixed line network. As fixed line services are disconnected and usage of the network declines, some assets will become redundant while other assets will become progressively under-utilised. If the costs associated with asset redundancy and under-utilisation are reflected in regulated revenues, then the unit costs of the declared fixed line services will rise and will rise exponentially as the migration nears its conclusion.
- The ACCC considers that the costs associated with this loss of economies of scale are caused by NBN migration and not by users of the fixed line network. The ACCC considers that such costs should not be reflected in regulated revenues or charges. The ACCC considers that Telstra has been provided with an opportunity to ensure that it would receive consideration through the DAs for the impact of the NBN on its fixed line assets.
- The ACCC maintains its draft decision that certain assets made redundant by the NBN will be treated as asset disposals. In addition, it is the ACCC's draft decision that adjustments will be made to allocation factors for under-utilised assets to remove the impact of lost economies of scale due to NBN migration on unit costs.
- The ACCC considers that its draft decision ensures that costs are allocated to services on the basis of cost causation and reflect the relative usage of Telstra's fixed line network by various services that continue to be supplied over the network.

4.1 Introduction

The NBN will replace Telstra's fixed line network as the infrastructure used to provide fixed line telecommunications services in Australia. The transition from Telstra's fixed line network to the NBN is occurring under arrangements between Telstra and NBN to migrate customers to the NBN and for NBN to lease and acquire certain infrastructure from Telstra. These arrangements will have significant impacts on the way Telstra's fixed line assets are used and are important considerations in determining prices for the declared services.

The current arrangements between Telstra and NBN are formalised in the 'Definitive Agreements'. The Definitive Agreements were first signed in June 2011 and reflected a predominantly fibre-to-the-premises (FTTP) network design for the NBN. In December 2014, Telstra and NBN signed revised Definitive Agreements which reflect the Government's multi-technology NBN policy. These arrangements between Telstra and NBN provide for the following key elements:

- customers will be migrated from Telstra's fixed line network as the NBN is rolled out
- NBN will lease certain infrastructure from Telstra
- certain assets will be transferred from Telstra to NBN.

The Definitive Agreements also provide for migration payments and infrastructure payments to be made by NBN to Telstra:

- NBN will pay Telstra a one-off migration payment for each end-user disconnected from its copper network when they are migrated to the NBN in areas covered by NBN's fixed line network.
- NBN will pay Telstra ongoing infrastructure payments for the lease of certain infrastructure. NBN will lease ducts, rack space in exchange buildings, and dark fibre (optical fibre with no active electronics attached) from Telstra. NBN will also pay Telstra a one-off payment for each lead-in conduit (that is, the pipe leading into a customer premise that houses the lead-in copper cable) that is transferred to NBN as customers are migrated to the NBN.

4.2 March 2015 draft decision

In the draft decision the ACCC reiterated and expanded on the positions set out in its October 2014 position statement on accounting for the arrangements between Telstra and NBN in determining prices for the declared fixed line services.

The ACCC stated in the draft decision that it would adopt a regulatory values approach to account for the impacts of the Telstra-NBN arrangements. Under this approach, adjustments would be made in the FLSM to account for the arrangements based on the values assigned to affected assets in the RAB, and not based on the value of payments received from NBN.²⁴⁸

The ACCC set out its draft decision on how it intended to implement the regulatory values approach. In particular, the ACCC stated that:

- 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.²⁴⁹

Regarding the last point, the ACCC considered that the progressive disconnection of customers from the fixed line network, for which Telstra will receive migration payments, will contribute to the under-utilisation of local switching equipment and will result in higher unit costs for the services that use these assets.²⁵⁰ The ACCC considered that it would be inappropriate for Telstra to recover, through regulated charges, higher unit costs that arise from the under-utilisation of local switching equipment caused by NBN migration. To ensure that these costs are not borne by users of the fixed line network, the ACCC treated a proportion of the regulatory value of local switching equipment as an asset disposal.²⁵¹

The ACCC also discussed the issue of the increase in unit operating costs over the next regulatory period that will occur as a result of the loss of economies of scale in the operation of

²⁴⁸ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, p. 136.

²⁴⁹ *ibid.*, p. 138-140.

²⁵⁰ The ACCC considered that local switching equipment is among the assets most directly impacted and potentially under-utilised as a result of NBN migration.

²⁵¹ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, p. 140.

the fixed line network as customers are migrated to the NBN. The ACCC noted that WIK-Consult identified the loss of economies of scale due to the NBN as an issue in its report on the efficiency and prudence of Telstra's expenditure forecasts.²⁵² The ACCC agreed with WIK that the loss of economies of scale in the provision of fixed line services is likely to be predominantly due to the NBN.²⁵³ Further, the ACCC considered that access seekers should not incur higher charges for fixed line services as a consequence of Telstra's decision regarding the future of its copper network.²⁵⁴

The ACCC noted that it would consider the issue of NBN-induced loss of economies of scale further, and invited comments from stakeholders.

4.3 Submissions

In February 2015, prior to the release of the draft decision, Telstra submitted a statement by its Deputy CFO, Mr Mark Hall, and a report by consultant Mr John Small. Both submissions addressed the positions taken by the ACCC in its October 2014 position statement on accounting for the impacts of the Telstra-NBN arrangements, which the ACCC reiterated in the draft decision.

Mr Hall states that [cic] [redacted]
[redacted]
[redacted]
[redacted] [cic]

The report by Mr Small argues that [cic] [redacted]
[redacted]
[redacted]
[redacted]
[redacted]
[redacted]
[redacted]
[redacted]
[redacted] [cic]

In response to the draft decision, Telstra submitted that the treatment of decommissioned and under-utilised assets as disposals would result in under-recovery and would be inconsistent with the fixed principles.²⁶¹ Telstra submitted that while the term 'asset disposal' is not defined in the fixed principles, it is well understood in accounting and regulatory economics to mean a transfer of an asset for consideration.²⁶² Telstra referred to reports by Mr Keith Lockey and Mr

252 *ibid.*, p. 140-141.
253 *ibid.*, p. 141.
254 *ibid.*, p. 141.
255 Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, Confidential version, p. 15.
256 *ibid.*, p. 7.
257 John Small, *Customer Migration Impacts on Telstra's Regulated Asset Base*, February 2015, p. 13.
258 *ibid.*, p. 16.
259 *ibid.*, p. 17.
260 *ibid.*, p. 18.
261 Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, pp. 36-38.
262 *ibid.*, p. 39.

Jeff Balchin to support this view.²⁶³ Telstra submitted that in the case of decommissioned and under-utilised assets, there will be no transaction in relation to the assets, no transfer of ownership, and no alternative avenue for the recovery of remaining costs. Telstra will continue to own the assets and they will not be transferred to NBN. Therefore, Telstra submits that it is incorrect to classify these assets as having been disposed of.

Telstra submitted that any adjustment made to operating expenditure forecasts to exclude the effects of NBN-induced loss of economies of scale would be inconsistent with the fixed principles.²⁶⁴ This is because the fixed principles require that forecast operating expenditures reflect prudent and efficient costs, and the impact of the NBN on demand for fixed line services cannot be said to reflect any imprudent decision by Telstra.²⁶⁵ Telstra submitted that in the absence of any finding by the ACCC that Telstra acted imprudently, there is no basis under the fixed principles to adjust operating expenditure forecasts to reflect the loss of economies of scale due to the NBN.²⁶⁶ Telstra referred to the report by Mr Balchin to support this view.²⁶⁷

Telstra submitted that Telstra did not cause the industry transition to the NBN; rather, as a result of government policy Telstra was required to choose whether or not it would cooperate with the structural reform and agree to progressively disconnect services from its fixed line network.²⁶⁸ Telstra submitted that there is therefore no basis for any finding by the ACCC that Telstra caused the loss of scale economies associated with NBN migration.²⁶⁹

Telstra further submitted that the payments it will receive under the Definitive Agreements do not compensate Telstra for any loss of economies of scale associated with NBN migration. Telstra submitted, referring to the statement by Mr Mark Hall, that Telstra would be exposed to a substantial loss of value irrespective of whether it cooperated in relation to the NBN rollout, and that the payments were not sufficient to fully address the anticipated loss of value.²⁷⁰

Telstra submitted that the 2011 FAD decision and the fixed principles provisions provide for the 'locking in' of an initial asset base and for this asset base to be rolled forward in each year in a predictable and transparent way.²⁷¹ Telstra submitted that the fixed principles do not allow the ACCC to 'optimise' the RAB ex post to reflect a forecast reduction in asset utilisation, and noted that the uncertainty associated with asset based optimisation under the ACCC's previous TSLRIC approach was a reason for adopting the building block approach.²⁷²

Finally, Telstra submitted that the ACCC's draft decision relating to NBN adjustments denies Telstra a reasonable opportunity to recover the direct costs of supplying the fixed line services, which would likely lead to an outcome that does not promote the LTIE.²⁷³

Frontier Economics (Frontier) noted WIK-Consult's recommendation that the under-utilisation of ducts and exchange buildings should not be allocated to fixed line users. Frontier submitted

²⁶³ Keith Lockey, *The basis of accounting for disposals of assets in Telstra's regulatory asset base for fixed line services*, April 2015, p 6; Jeff Balchin, *Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services*, April 2015, p 3.

²⁶⁴ Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 43.

²⁶⁵ *ibid.*, p. 44.

²⁶⁶ *ibid.*, p. 44.

²⁶⁷ Jeff Balchin, *Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services*, April 2015, p 20.

²⁶⁸ Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 46.

²⁶⁹ *ibid.*, p. 46.

²⁷⁰ *ibid.*, pp. 46-50.

²⁷¹ *ibid.*, p. 50.

²⁷² *ibid.*, pp. 50-51.

²⁷³ *ibid.*, p. 51.

that the ACCC should account for this under-utilisation by treating a proportion of the ducts and pipes asset class, and a proportion of exchange-related assets, as a disposal in each year.²⁷⁴

Further, Frontier submitted that NBN migration is a voluntary action by Telstra backed by payments for its migration of customers. Frontier submitted that access seekers are not responsible for the migration and derive no direct benefits from the Telstra-NBN agreements and should not be forced to bear its consequences.²⁷⁵ Frontier submitted that a ‘top-down’ approach to expenditure forecasts — whereby forecasts are determined by reducing base year costs in proportion to the change in SIOs due to the NBN rollout — would ensure that access seekers are no worse off as a result of the rollout.²⁷⁶

Optus submitted that it supports the ACCC’s positions on accounting for the Telstra-NBN arrangements and the proposed method of treating assets as disposals.²⁷⁷ Optus submitted that the payments to Telstra from NBN under the Definitive Agreements should be assumed to adequately compensate Telstra for any loss of scale due to the transition to the NBN.²⁷⁸ Further, Optus submitted that the costs associated with under-utilised ducts and building space should not be allocated to regulated fixed line services,²⁷⁹ but be treated as an NBN-related asset disposal.

4.4 ACCC further draft decision

This section sets out the ACCC’s draft decision on how it will account for the impact of the NBN in determining prices for the declared fixed line services. Section 4.4.1 below outlines the ACCC’s position on accounting for the impact of the NBN. Sections 4.4.2 and 4.4.3 discuss the implementation of this position for the purposes of this FAD inquiry.

4.4.1 ACCC position on accounting for the impact of the NBN

The ACCC’s draft decision is that users of the fixed line network should not bear the costs associated with the loss of economies of scale that will occur as a result of NBN migration. Under the Telstra-NBN arrangements, Telstra will progressively disconnect customers from its fixed line network as the NBN is rolled out. In addition, under the arrangements Telstra has undertaken to only provide fixed line services over the NBN where the NBN is deployed. Therefore, as NBN migration continues, certain assets will become redundant and there will be growing excess capacity in the fixed line network, resulting in rising unit costs of providing fixed line services. However, users of the fixed line network are not causing this redundancy and excess capacity and, as a result of the arrangements, will not use it.

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. The ACCC considers that 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. As discussed in the following section, the ACCC is making adjustments in the FLSM to ensure that users of the fixed line network do not bear costs that are caused by NBN migration.

The reasons for the ACCC’s draft decision are set out in more detail below.

²⁷⁴ Frontier Economics, *Submission on the ACCC’s draft decision on fixed line prices, A Report Prepared For the Competitive Carriers Coalition, iiNet and Optus*, May 2015, pp. 22-23.

²⁷⁵ *ibid.*, p. 14.

²⁷⁶ *ibid.*, p. 28.

²⁷⁷ Optus, *Submission in response to ACCC Draft Decision, Public Inquiry into final access determinations for fixed line services – primary price terms*, April 2015, p. 8.

²⁷⁸ *ibid.*, p. 5.

²⁷⁹ *ibid.*

Impact of NBN migration on fixed line assets

As noted above, the transition to the NBN is occurring under the Telstra-NBN arrangements, which provide for the migration of customers from Telstra's fixed line network to the NBN, as well as the selling and leasing of certain infrastructure to NBN.

These arrangements will result in certain fixed line assets becoming redundant during the next regulatory period. An example of this asset redundancy is the copper cable which runs from the exchange to each end-user premises in the fixed line network. When a fixed line customer is migrated to the NBN they will be permanently disconnected from the fixed line network. In areas where copper cables will not form part of the NBN (that is, FTTP and HFC regions), the copper cable that was previously used to deliver fixed line services will no longer be used, and will therefore become redundant. If the costs associated with assets made redundant by NBN migration, such as decommissioned copper cables, are reflected in regulated revenues, then the unit costs of services supplied using these assets will rise (all else being equal).

The ACCC considers that the assets that will become redundant as a result of NBN migration are generally those that are in the CAN, with the exception of ducts and pipes, exchange and land assets, and indirect assets.

Further, the arrangements will result in certain fixed line assets becoming progressively under-utilised as NBN migration continues. An example of this under-utilisation is PSTN local switching equipment. As noted above, when a fixed line customer is migrated to the NBN they will be permanently disconnected from the fixed line network. As a result, these customers will no longer contribute to the voice traffic traversing the PSTN and there will be a growing amount of excess capacity in the network. If the costs associated with this NBN-induced excess capacity are reflected in regulated revenues, then the unit costs of services supplied using these assets will rise (all else being equal).

The ACCC considers that the assets that will become progressively under-utilised as a result of NBN migration are all those that do not fall into the 'redundant asset' category discussed above.

The ACCC notes that these are illustrative examples that provide a straightforward conceptualisation of how NBN migration will physically affect these two 'types' of asset. Notwithstanding how various assets are categorised, the progressive migration of fixed line customers to the NBN will result in an increase in unit costs generally. Under Telstra's cost allocation framework, these additional costs will be borne by users of the fixed line network.

Payments received under the Definitive Agreements

Under the Definitive Agreements (DAs), Telstra will receive a disconnection payment each time a customer is migrated to the NBN. Under the original agreements, Telstra calculated the net present value of these payments to be \$4 billion as at June 2010. Telstra has stated that the net present value of the payments under the revised agreements (executed in December 2014) has been 'preserved on a like for like basis'.²⁸⁰

Telstra is receiving these payments specifically in respect of the disconnection of customers from its fixed line network. In addition, under the DAs Telstra has undertaken to only provide fixed line services over the NBN where the NBN is deployed.²⁸¹ Therefore, Telstra will be receiving a financial benefit in return for the permanent loss of wholesale and retail customers on its fixed line network.

Telstra's submission to the draft decision regarding the DA payments is based on providing evidence which in its view demonstrates that the payments it receives are [cic] [REDACTED]

²⁸⁰ Telstra, *Media release: Telstra signs revised NBN Definitive Agreements*, December 2014, p. 1.

²⁸¹ Telstra, *Media release: Telstra signs NBN Definitive Agreements*, June 2011, p. 8; Telstra, *Media release: Telstra signs revised NBN Definitive Agreements*, December 2014, p. 12.

[redacted] [cic] While not entering into the merits of Telstra's arguments regarding the sufficiency or otherwise of the payments it receives under its arrangements with NBN, the ACCC considers that such arguments are not relevant to its draft decision to make adjustments to remove the costs associated with NBN-induced lost economies of scale from regulated revenues. The ACCC reiterates that in accounting for the Telstra-NBN arrangements in determining prices for the declared services, it has not considered the quantum of the payments received by Telstra, but rather has had regard to the NBN arrangements and to the regulatory value of relevant assets.

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.

4.4.2 Implementation

As discussed above, the ACCC considers that users of the fixed line network should not bear the costs associated with the loss of economies of scale that will occur as a result of NBN migration. In order to ensure that these costs are not reflected in charges for regulated fixed line services, the ACCC has made 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.
- 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.

The adjustments to cost allocation factors are intended to give effect to the ACCC's draft decision is that the increased unit costs associated with NBN-induced under-utilisation should not be allocated to fixed line services. In order to give effect to this position, the ACCC has made adjustments to cost allocation factors using what Analysys Mason refers to in its report as an 'incremental costing' approach, whereby the cost of spare capacity within an asset is measured as the difference between the total cost of the assets with spare capacity and the cost of the assets if there were no spare capacity.²⁸³

The adjustments in the FLSM involve the following steps:

- Step 1: Estimate unit costs for each asset class that would result if NBN-induced under-utilisation did not occur. These unit costs are estimated by replacing FLSM expenditure and demand inputs with ones that do not account for the impact of the NBN. For capital expenditure and demand, Telstra's forecast model is used to determine pre-NBN forecasts. For operating expenditure, base year costs for each asset class are held constant in real terms over the regulatory period. In addition, adjustments are made to cost allocations to remove NBN-related adjustments.
- Step 2: Calculate the proportionate difference between unit costs calculated by the FLSM (using draft decision inputs and unadjusted cost allocation factors) and the unit

²⁸² Telstra, *Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision*, 1 May 2015, p. 48.

²⁸³ Analysys Mason, *Assessment and verification of inputs into Telstra's Cost Allocation Framework*, June 2015, p. 17.

costs estimated under Step 1. This difference represents the per asset class cost of NBN-induced excess capacity as a proportion of total unit costs.

- Step 3: Scale down allocation factors for each asset class by the proportionate cost of excess capacity calculated under Step 2. That is, multiply allocation factors by 1 minus the proportionate difference in unit costs arising from NBN-induced excess capacity.

The effect of these adjustments is to ensure that unit costs for each asset class do not rise as a result of under-utilisation caused by NBN migration.

4.4.3 ACCC views on implementation

The ACCC notes that the adjustments described above maintain the NBN-related adjustments made for the March 2015 draft decision. Treating the sale and decommissioning of copper cables and local switching equipment as disposals, and the use of allocation factors to reflect the leasing of various assets to NBN, is maintained.

This section provides the ACCC's views on the implementation of the adjustments described above, and how they relate to the fixed principles and the ACCC's March 2015 draft decision.

Treatment of redundant assets as disposals

As noted above, the ACCC's draft decision is to treat a proportion of the regulatory value of assets made redundant by NBN migration as an asset disposal. This proportion is determined based on the forecast of the rate of NBN rollout.

The ACCC considers that treating assets made redundant by NBN migration as disposals is consistent with the fixed principles. In forming this view, the ACCC has considered the Australian Accounting Standards Board's (AASB) approach to disposals. The ACCC considers that the approach to disposals must be considered in the context of the building block model approach in the fixed principles provisions, and that 'disposals' has an ordinary meaning.²⁸⁴ Under the AASB Standard 'Property, Plant and Equipment' (AASB 116), an asset is disposed at the end of its 'useful life', which is defined in terms of the asset's expected utility to the entity. A range of factors are considered in determining the useful life of an asset, including:

...technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.

Therefore, according to AASB 116, an asset may be disposed if it becomes commercially obsolescent—that is, if it is no longer required as a result of a change in market demand for the product or service output of the asset. The ACCC considers that this is a relevant factor in determining whether an asset has been disposed of for the purposes of the RAB roll-forward mechanism. The ACCC considers that all assets that become redundant as a result of NBN migration will be commercially obsolescent, as each of these assets will no longer be required after customers are disconnected from the fixed line network. The ACCC notes that Telstra has acknowledged the relationship between commercial obsolescence and the useful life of assets.²⁸⁵

²⁸⁴ The ACCC notes that the Australian Accounting Standards Board has noted that the term 'disposal' is not defined in the Australian Accounting Standards and that the Board has referred to common definition of that term (Australian Accounting Standards Board, *Issues Paper Definition and application of residual value*, AASB meeting 3-4 September 2014, Agenda Paper 17.2 (M140), paragraph 6).

²⁸⁵ According to the statement by Telstra's Deputy CFO: [cic] [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] [cic]

The ACCC, having had regard to relevant cost accounting standards, and Telstra's confirmation of its compliance with such standards, is of the view that the removal of assets made redundant by NBN migration from the RAB by treating them as asset disposals is consistent with the fixed principles. In particular, the ACCC considers that reducing the RAB by an amount which is defined as an asset disposal and which reflects the regulatory value of assets being made redundant as a result of NBN migration in a given year is consistent with the RAB roll-forward mechanism specified in clause 6.7 of the fixed principles. The ACCC considers that whether or not an asset has been disposed of for the purposes of the building block model approach in the fixed principles provisions should not be limited to a transaction whereby the asset has been sold, and should include circumstances in which an asset has ceased to be used.

The ACCC notes the view of Mr Balchin, quoted in Telstra's submission, 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 the assets in question.²⁸⁶

As noted above, the ACCC considers that a relevant factor in determining whether an asset has been disposed of for the purposes of the building block model approach is whether it is commercially obsolescent—that is, if it is no longer required as a result of a change in market demand for the product or service output of the asset. Whether a disposal transaction occurs and the nature of such a transaction is incidental to this core factor.

Adjustment of allocation factors to reflect under-utilisation

The ACCC notes that in its implementation of the incremental costing approach to account for NBN-induced under-utilisation, the spare capacity costs that are measured and used to adjust allocation factors are intended to reflect those that are caused by NBN migration alone. That is, any spare capacity that is caused by other factors (such as the substitution of fixed line to mobile services) is not adjusted for. This is consistent with the ACCC's March 2015 draft decision, in which it considered it appropriate that the cost impacts of non-NBN sources of declining demand should be shared among all users of the fixed line network.²⁸⁷

The ACCC notes that all allocation factors are determined in the first instance as if no NBN-related adjustments are made (with the exception of Telstra's own adjustments to reflect the leasing of assets by NBN). The ACCC's adjustments are made to final allocation factors with the intention of removing the costs associated with NBN-induced under-utilisation. This means that all allocation factors will respond independently to other sources of declining demand for fixed line services.

As noted above, reflecting the decommissioning of copper cables and local switching equipment as disposals as set out in the draft decision is maintained under the adjustments set out above. However, in the case of local switching equipment, the ACCC considers it appropriate to treat only the proportion of the local switching equipment asset class whose costs are driven by ports (as determined within Telstra's allocation framework) to be treated as an asset disposal. This is because it is this component of the asset class that becomes obsolescent as services are disconnected. The remaining asset costs are driven by traffic volumes and relate to switching equipment that will remain in operation for a period during NBN migration. The traffic-driven component of local switching equipment is captured under the ACCC's under-utilisation adjustments.

The ACCC notes that its adjustments to allocation factors include the data equipment asset class. In the March 2015 draft decision, the ACCC considered data equipment to be an asset directly impacted by NBN migration. The ACCC considered, however, that adjustments to

²⁸⁶ Telstra, *Public inquiry into final access determinations for fixed line services – primary prices*, Response to Draft Decision, 1 May 2015, p. 39

²⁸⁷ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*, March 2015, pp. 150-153.

account for any under-utilisation of this asset class were not required because its RAB value is forecast to fall in line with the forecast number of ADSL SIOs over the regulatory period.²⁸⁸ While this remains the case, the incremental costing approach used by the ACCC to measure the cost of excess capacity has identified a significant proportion of the costs of the data equipment asset class as being attributable to the loss of economies of scale caused by NBN migration. The ACCC has adjusted cost allocation factors for all under-utilised assets to ensure that such costs are not allocated to fixed line services in accordance with its draft decision that users of the fixed line network should not bear these costs.

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.

The ACCC's adjustment of allocation factors to reflect under-utilisation caused by migration to the NBN is consistent with the fixed principles. Users of the fixed line network are not causing the excess capacity created by NBN migration, and the arrangements between Telstra and NBN ensure that they will not use this excess capacity. Telstra had an opportunity to ensure that it would receive consideration for the loss of economies of scale in the operation of its network caused by NBN migration. In this context, the ACCC considers that the allocation of the costs under its approach reflect the relative usage of Telstra's fixed line network by various services that continue to be supplied over the network. Further, the cost allocation factors under the ACCC's approach reflect causal relationships between supplying services and incurring costs. That is, the costs of this type of excess capacity will not be allocated to the services that continue to be supplied over the network, where the cause of that excess capacity is not related to supplying those services.

²⁸⁸ *ibid*, pp. 139-140.

5 Cost allocation

Key Points

- Cost allocation factors are used to allocate Telstra's costs to declared fixed line services. Costs allocated to declared services form the basis for setting prices of declared services.
- Telstra has proposed that a fully allocated cost framework, which takes into account all services supplied on the fixed line network, should be adopted for the next regulatory period. Telstra has submitted a detailed cost allocation model that reflects a fully allocated framework.
- In the draft decision the ACCC's indicated it would adopt a fully allocated cost framework in the next regulatory period.
- Following the draft decision the ACCC engaged Analysys Mason to undertake further assessment of Telstra's proposed cost allocation framework. This assessment included a review of inputs into the model to verify that the proposed cost allocation framework is based on accurate information, has been developed using reasonable methods and assumptions, and appropriately reflects forecast relative use by relevant services.
- In its report on its findings and recommendations, Analysys Mason provides a framework for allocating costs associated with overcapacity (or loss of economies of scale) caused by migration to the NBN. It also provides specific recommendations on cost allocation factors for each of the 22 asset classes.
- The ACCC's further draft decision on cost allocation is:
 - subject to a number of specific changes recommended by Analysys Mason, to adopt Telstra's proposed cost allocation framework as the starting point for allocating costs to declared services over the next regulatory period (discussed in this chapter), and
 - to make further adjustments to cost allocation factors to account for the loss of economies of scale caused by the migration of customers to the NBN (discussed in chapter 4).

5.1 Introduction

Telstra's fixed line network is used to provide both declared and non-declared services. Cost allocation factors are used in the Fixed Line Services Model (FLSM) to allocate a share of each asset class's total revenue requirement to individual declared services to estimate the costs of providing these services. Prices for declared services are then calculated based on costs allocated to these services.

The majority of cost allocation factors for the 2011 FADs were based on a model previously developed by Analysys Mason (the Analysys model).²⁸⁹ The ACCC modified the Analysys model's allocation factors to reflect that the model assumed an optimised network and did not include all asset classes making up the FLSM to determine the allocation framework for the 2011 FADs. This framework was a 'partially allocated' approach in that it considered changes

²⁸⁹ The Analysys model was a TSLRIC+ model developed in 2007-08 before the building block model was adopted by the ACCC.

in demand for only declared services and did not take into account other services that use fixed line assets.

Telstra has proposed that a fully allocated cost framework for setting prices should be adopted in the FADs for the next regulatory period. A fully allocated approach allocates all the costs of the fixed line assets. Costs are explicitly allocated to non-declared services as well as declared services that use the fixed line network, taking into account relative usage of the network by all services. Telstra has also developed a detailed model based on a fully allocated approach using forecast demand for declared and non-declared fixed line services and also other services that use fixed line assets.²⁹⁰

Following the release of the draft decision, the ACCC engaged Analysys Mason to undertake a further assessment of Telstra's proposed cost allocation framework (CAF). This chapter sets out the ACCC's draft decision on key aspects of the cost allocation framework used to determine primary price terms for the declared fixed line services. It focusses on Analysys Mason's findings and recommendations and the ACCC's position on the inputs, assumptions and methodologies used in Telstra's proposed model to reflect usage by various services (the ACCC's adjustments to cost allocation factors to account for the loss of economies of scale caused by the NBN is discussed in chapter 4).

5.2 March 2015 draft decision

The ACCC's draft decision was to adopt a fully allocated cost framework to determine the costs of supplying declared services in the next regulatory period. The ACCC noted the following main reasons for adopting this position:²⁹¹

- it will provide the opportunity for Telstra to recover the efficient costs of providing declared services and provides incentives for efficient investment in the network.
- it is most likely to reflect relative use of Telstra's fixed line network and in turn determine an appropriate share of costs to allocate to declared services
- it is an appropriate basis for explicitly accounting for the use of Telstra's infrastructure by NBN Co and other NBN related impacts
- it is consistent with the fixed principles provisions on cost allocation.

The draft decision also noted the various implications for how impacts of declining demand are shared between access seekers, Telstra and other users of the fixed line network. The ACCC stated its view that it is appropriate for the impact of declining demand due to the shrinking fixed line market to be shared by all users of fixed line assets, as would occur under a fully allocated framework. The ACCC also considered that there was no justification for any adjustment to the fully allocated approach to account for loss of market share and that there are no grounds for reconsidering initial RAB values as a result of changing to a fully allocated approach.²⁹²

The ACCC considered that Telstra's proposed cost allocation model is likely to be an appropriate implementation of a fully allocated approach but that further assessment and verification of inputs into the model would need to be undertaken between draft and final decisions.²⁹³ The ACCC noted that many of the inputs into the CAF for reflecting use of fixed line assets by various sources were obtained or adapted from internal Telstra databases for

²⁹⁰ Telstra, *Cost Allocation Framework for the ACCC Fixed Line Services Model - Framework and Model Guide*, Version 1, July 2014

²⁹¹ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms*, Draft decision, March 2015, p. x

²⁹² *ibid.*, pp. 152-154

²⁹³ ACCC, *Public inquiry into final access determinations for fixed line services – primary price terms*, Draft decision, March 2015, pp. xi-xii

which the ACCC and other parties do not have visibility. The ACCC stated that, before it could reach a draft decision on cost allocation, it would need to undertake an assessment of Telstra's CAF. This assessment would include a review of inputs into the model to verify that the proposed CAF is based on accurate information, has been developed using reasonable methods and assumptions, and appropriately reflects forecast relative use by relevant services.

Further, and as noted in chapter 4, the ACCC noted that unit operating costs would increase over the next regulatory period as services are migrated off the Telstra network and onto the NBN. This rise in unit operating costs results from a loss of economies of scale and density in the operation of Telstra's network as services are disconnected. The ACCC considered that the loss of economies of scale and density is incremental to the NBN and was still considering its approach on this issue. This view was also held by Wik-Consult, which raised concerns about users of fixed line services bearing higher costs resulting from the NBN, including specific concerns around cost allocation factors for a number of asset classes, including ducts and pipes and copper cables.²⁹⁴

5.3 Submissions

Stakeholders made the following comments in relation to cost allocation factors in their submissions.

Adoption of a fully allocated model

Telstra welcomed the ACCC draft decision to adopt a fully allocated model and the opportunity to work with the ACCC and its consultant on further clarifying its proposed CAF.²⁹⁵ Optus²⁹⁶ and iiNet²⁹⁷, while not explicitly opposing the introduction of a fully allocated approach, raised some issues with Telstra's implementation of this approach, including issues around transparency and the need to appropriately reflect the impacts of the NBN and ensure the impacts of declining use of fixed line services by declared services caused by the NBN are not borne by users of fixed line services. Conversely, Frontier Economics (Frontier) on behalf the Competitive Carriers Coalition, Optus and iiNet did not agree with the change to a fully allocated approach and questioned why the ACCC decided not to tie cost allocations to demand forecasts directly within the existing model instead of using Telstra's fully allocated costing approach.²⁹⁸

Loss of economies of scale due to the NBN rollout

Optus argued that a fully allocated model would only be appropriate if changes to the model as recommended by the WIK-Consult report are adopted. The recommendations include the following.²⁹⁹

- Telstra's proposed cost allocation approach should be amended to better reflect the allocation of costs to regulated fixed line services, non-regulated fixed line services, NBN and other services.
- The costs of unused or underutilised building space as a result of NBN migration should not be allocated to regulated services. Instead, such assets should be treated as asset disposal or the cost should be allocated to NBN.

²⁹⁴ WIK-Consult, *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, 5 March 2015, pp. 19-20.

²⁹⁵ Telstra, *Response to Draft Decision*, 1 May 2015, p.175.

²⁹⁶ Optus, *Submission in response to ACCC Draft Decision*, April 2015, pp.12-26.

²⁹⁷ iiNet, *Submission by iiNet Limited*, May 2015, pp. 4-6.

²⁹⁸ Frontier Economics, *Submission on the ACCC's draft decision on fixed line prices – A report prepared for the competitive carriers coalition, iiNet and Optus*, May 2015, p. 15.

²⁹⁹ Optus, *Submission in response to ACCC Draft Decision*, April 2015, public version, p. 5.

- The costs associated with transmission assets should be allocated on a per Mbps basis and demand driven transmission should be allocated to non-regulated fixed line services.
- The costs of empty or underutilised ducts should not be allocated to regulated fixed line services, but treated as an NBN-related asset disposal.
- The costs associated with data services should reflect the likely usage of relevant assets by Telstra's NBN services – as the majority of core data assets are used by all Telstra end-users irrespective of the access technology.

Frontier also referred to the WIK report and stated that corrections for diseconomies of scale should apply to all costs.³⁰⁰

Telstra submitted that it does not accept that it should be the only user of the fixed line network that is required to bear the rising unit costs which result from the implementation by Telstra of the Government's NBN policy. Telstra disagrees with the Wik-Consult's suggestions that Telstra's commercial arrangements with NBN Co either caused the NBN migration to occur, or that they otherwise compensate Telstra for these diseconomies and transition costs.³⁰¹

Transparency of Telstra's proposed cost allocation framework

Submissions from Frontier³⁰² and iiNet³⁰³ noted transparency issues in Telstra's cost allocation framework and stated concerns regarding procedural fairness in relation to Telstra's submission of its cost allocation framework.³⁰⁴ Optus submitted that it supports the use of cost allocators that reflect the reason for which costs are to be incurred or that reflect the level of demand for the asset, while Telstra is proposing to use several cost allocators which are at odds with the cost causation principle.³⁰⁵ Telstra submitted that the ACCC and Analysys Mason have approached Telstra for a considerable amount of further information since the draft decision was published and they are willing to provide more information to verify the inputs for the cost allocation framework.³⁰⁶

Transmission costs

Transmission capacity costs were another issue raised by the stakeholders in their submissions. Frontier stated that the regulated fixed line services are less likely to be a demand driver for transmission investment as demand for these services is declining.³⁰⁷ Telstra submitted that its capacity based approach to allocating transmission costs is highly conservative and results in less costs being allocated to declared services compared with the approach previously adopted by the ACCC under the Analysys Mason model.³⁰⁸

General allocators

In order to respond to the ACCC's query regarding the general allocator for certain FLSM assets, Telstra undertook further analysis to develop a specific allocator for CO09 (Core network buildings and support) and compared this to the general allocator for that asset class.

³⁰⁰ Frontier Economics, *Submission on the ACCC's draft decision on fixed line prices – A report prepared for the competitive carriers coalition, iiNet and Optus*, May 2015, p. 36.

³⁰¹ Telstra, *Response to Draft Decision*, 1 May 2015, p. 5.

³⁰² Frontier Economics, *Submission on the ACCC's draft decision on fixed line prices – A report prepared for the competitive carriers coalition, iiNet and Optus*, May 2015, p. 11.

³⁰³ iiNet, *Submission by iiNet Limited*, May 2015, p. 6.

³⁰⁴ *ibid*, p. 6.

³⁰⁵ Optus, *Submission in response to ACCC Draft Decision*, April 2015, p. 12.

³⁰⁶ Telstra, *Response to Draft Decision*, 1 May 2015, p. 175.

³⁰⁷ Frontier Economics, *Submission on the ACCC's draft decision on fixed line prices – A report prepared for the competitive carriers coalition, iiNet and Optus*, May 2015, p. 27.

³⁰⁸ Telstra, *Response to Draft Decision*, 1 May 2015, pp. 178-180.

Telstra found that the general allocator method used is reasonable and is likely to understate the cost otherwise attributable to the declared fixed-line services.³⁰⁹

5.4 ACCC further draft decision

The ACCC reiterates its position from the draft decision that a fully allocated approach is an appropriate approach for allocating the costs of Telstra's fixed line network. It maintains its view that a fully allocated approach is compatible with the building block methodology; is likely to result in prices that reflect the relative cost of supplying declared fixed line services; and forms an appropriate basis for accounting for NBN related impacts.

The ACCC engaged Analysys Mason to undertake the further assessment and verification of Telstra's cost allocation framework and to advise on assumptions and methodologies used in the calculation of cost allocation factors. Analysys Mason provided a final report on its findings and recommendations on 16 June 2015.³¹⁰

The ACCC's further draft decision on cost allocation is as follows:

- Telstra's proposed cost allocation framework has been assessed by Analysys Mason. Overall, Analysys Mason has found that the proposed cost allocation framework is based on accurate and verifiable information; is based on reasonable assumptions and calculation methods and reasonably reflects how fixed line assets are used by various services. Subject to a number of specific changes recommended by Analysys Mason, the ACCC intends to adopt Telstra's proposed cost allocation framework as the starting point for allocating costs to declared services over the next regulatory period.
- The ACCC will make further adjustments to cost allocation factors for 15 asset classes to account for the loss of economies of scale caused by the migration of customers to the NBN. As discussed in chapter 4, these adjustments will scale down allocation factors for each asset class by the proportionate cost of NBN induced excess capacity. This will ensure that higher costs associated with the migration to the NBN will not be borne by remaining users of fixed line services. This approach aligns with general recommendations made by Analysys Mason for addressing the issue of increasing excess capacity caused by the NBN for assets that become progressively underutilised as the NBN is rolled out. The size of the ACCC's proposed adjustment to allocation factors to account for costs of excess capacity caused by the NBN, is estimated by reference to unit costs for each asset class that would result if NBN-induced under-utilisation did not occur in accordance with the approach recommended by Analysys Mason.

The remainder of this chapter provides further details on the key findings and recommendations of Analysys Mason and the ACCC's further draft decision on the specific recommendations of Analysys Mason for each asset class.

5.4.1 Analysys Mason report

The Analysys Mason report is broadly structured into two sections. The first section develops a framework for assessing Telstra's proposed CAF based on various principles. The second section provides Analysys Mason's specific findings and recommendations on each asset class.³¹¹ The key points from the Analysys Mason report are summarised below.

³⁰⁹ *ibid*, pp. 175-178.

³¹⁰ Analysys Mason, *Assessment and verification of inputs into Telstra's Cost Allocation Framework*, 16 June 2015. A public version of Analysys Mason's report is available on the ACCC website. Access seekers that have entered confidentiality arrangements with Telstra will be provided with access to the confidential version.

³¹¹ This includes an assessment of routing factors, which are used to calculate cost allocation factors for a range of core asset classes.

Framework for assessment

Analysys Mason's framework for assessing Telstra's proposed CAF is based on the long-term interests of end-users (LTIE) objective of Part XI of the *Competition and Consumer Act 2010* and the fixed principles relating cost allocation factors. The framework then incorporates the five cost allocation principles used by Ofcom as an example of international best practice. Ofcom's cost allocation principles are cost causation, distribution of benefits, cost minimisation, effective competition and practicality.³¹² Analysys Mason also provides a reconciliation between Ofcom's cost allocation principles, the LTIE objective and the fixed principles provisions.

Analysys Mason then presents a framework for allocating Telstra's fixed line costs based on these principles and the ACCC draft decision on the impacts of the NBN. Analysys Mason's framework broadly consists of the following steps:

- *Assets that progressively become redundant* as the NBN is rolled out should be removed from the RAB through the asset disposal mechanism.
- *Assets that are not made progressively redundant* as the NBN is rolled out but that become progressively underutilised should remain in the RAB, but the cost allocation framework should allocate excess capacity appropriately.³¹³

For the second group of assets under Analysys Mason's framework, efficient costs would be allocated across all appropriate services in line with the principles of cost causation, distribution of benefits, cost minimisation, effective competition and practicality. Remaining costs would reflect overcapacity or loss of economies of scale that even an efficient operator would incur. The framework then provides for overcapacity (or loss of economies of scale) to be allocated in the following two ways:

- *Allocation by equi-proportional mark-up (EPMU) on current usage:* Analysys Mason recommends that this method be used in two instances. The first is when overcapacity is not measurable or allocable. In this case, overcapacity cannot be attributed to a particular identified service and should be considered a cost or benefit to all services. The second is when overcapacity is measurable and allocable, but the overcapacity is available to be used by any party (or service).
- *Allocation to single party or service:* Analysys Mason recommends that allocation of excess capacity to a single party be made if only that single party or service can use the capacity. In this case the party or service that has the right to use the overcapacity should bear that cost. In the case of overcapacity caused by the NBN, that party (or service) could be 'Telstra Corporate' or 'NBN-Telstra agreement' cost centre rather than to Telstra fixed line services, if the benefit is not specific to fixed line services. Although there is explicit NBN use of infrastructure, NBN services do not make use of overcapacity, since the NBN lease payments only pay for the right to use defined quantities of Telstra assets which are transferred or leased to it. It is not the NBN services that cause the overcapacity as such, but rather the nature of Telstra's arrangements with NBN. Analysys Mason recommend that an allocation of overcapacity to a single party only be made if the overcapacity is measurable and allocable (if it is not then an EPMU should be used).

Analysys Mason further provides two ways for measuring overcapacity.

- *Average costing:* each service pays for its own use according to its use of the capacity, and the remaining cost is the spare capacity. Analysys Mason suggest that this approach may result in the calculated cost of overcapacity being high even if the incremental cost of the spare capacity is low.

³¹² Ofcom, http://www.ofcom.org.uk/static/archive/oftel/ind_info/numbering/mnpdetre.pdf , pp. 5-6.

³¹³ Analysys Mason, *Assessment and verification of inputs into Telstra's Cost Allocation Framework*, 16 June 2015, pp.13-14.

- *Incremental costing*: the cost of spare capacity is the difference between the total cost of the assets and the cost of the assets that would have zero spare capacity. Analysys Mason suggest that this approach may be difficult to implement, since it requires extensive data on costs and capacities in scenarios with and without the spare capacity in place.

Recommendations on specific asset classes

Analysys Mason has also provided an assessment for each of the 22 asset classes. Analysys Mason's specific recommendations on each asset class relate to the verification of inputs into Telstra's proposed cost allocation framework and assumptions and methodologies used to determine forecast usage by the various services that use Telstra's fixed line assets.

For 10 out of the 22 asset classes, Analysys Mason has found that the inputs into the calculation of cost allocation factors could be verified to a reasonable degree of satisfaction and are reasonable. For the remaining 12 asset classes, Analysys Mason has recommended the following adjustments:

- *CA01: Ducts and pipes* – Analysys Mason identified some limitations to the approach taken by Telstra to produce the cost allocation factors for this asset class and recommended some amendments.³¹⁴ Forecasts used in the calculation of cost allocation factors assume that ducts and pipes in NBN areas where fibre-to-the-premise or fibre-to-the-distribution point (FTTP/dp) or hybrid fibre-coaxial (HFC) is deployed will continue to be used for fixed line services. Analysys Mason suggested that there should be a commensurate deduction in the fixed line use where FTTP/dp or HFC is deployed. Analysys Mason produced amended forecast fixed line use to deduct the growth in FTTP/dp and NBN HFC duct usage. Analysys Mason has also recommended that fixed line duct usage should be reduced by [c-i-c starts] [c-i-c ends] for every 1m of duct usage by NBN Co in FTTP/dp, FTTN or HFC to reflect the relatively larger duct usage requirement for the fixed line network compared to the NBN.
- *CA08: Network land and CA09: Network buildings/support* - Telstra applies a land value modification to asset classes CO07, CO08 and CO09. This reflects the higher value of exchange space in urban areas than in outlying areas, based on a land valuation exercise carried out by PwC in 2007. Analysys Mason agrees that this approach is logical and for reasons of consistency recommends that the land value modification is also applied to asset classes CA08 and CA09.³¹⁵
- *CO01: Switching equipment (local)* - The port component of local switching assets is scalable while the remaining traffic-driven component is not scalable. In Telstra's asset register, a large category [c-i-c starts] [c-i-c ends] is allocated to the traffic driven category. Analysys Mason recommends that [c-i-c starts] [c-i-c ends] of the asset class value should be removed through the asset disposal mechanism. Therefore, the port-traffic distinction should be removed from the CAF and the calculation that allocates port-driven costs should be removed. This should leave the calculation that allocated the traffic driven component on the basis of SIOs.
- *CO02: Switching equipment (trunk) and CO03: Switching equipment (other)* - As the legacy switching equipment can be reused by subscribers who have been migrated to the NBN access network with the use of trunk gateways, Analysys Mason recommends maintaining the use of MOU as the basis for the allocation and modifying the forecast

³¹⁴ *ibid*, p. 34

³¹⁵ *ibid*, pp. 42-44.

used to keep the volume of PSTN subscribers broadly constant (e.g. pre NBN forecast).³¹⁶

- *CO04: Inter-exchange cables* – Analysys Mason recommends that the platform allocation should be updated using March 2015 NDS platform allocation data. This will enable the extrapolation from a one-year period rather than a six-month period.
- *CO05 : Transmission equipment* – Analysys Mason recommends rebasing the transmission technology distribution in order to keep the ‘other’ category constant, whilst the remaining categories vary as per the current approach.
- *CO07: Other communications plant and equipment/ CO08: Network land/ CO09 : Network buildings/support* – Analysys Mason recommends reviewing the rack usage forecasts when the CAF is updated to ensure that it takes account of the latest available information. Analysys Mason also suggests keeping the TEBA rack forecast static at 2013/14 levels.
- *CO12: Data equipment* – Analysys Mason recommends allocating subscriber and throughput driven components separately. According to Analysys mason, it would be more in line with principles of cost causation to base cost allocation of this asset class on metrics like routers, switches, software licences etc. rather than only subscribers.

Analysys Mason has also identified some particular asset classes where increasing excess capacity caused by the NBN is likely to be an issue. It has not provided any specific recommendations on how adjustments to cost allocation factors to address the issue of overcapacity should be implemented for these asset classes, but has provided suggestions for how such adjustments could be made.

5.4.2 ACCC response to Analysys Mason recommendations on specific asset classes

For the 10 asset classes that Analysys Mason has not recommended any specific changes, the ACCC proposes to adopt Telstra’s proposed cost allocation factors either without modification, or as a starting point for adopting further adjustments to account for the loss of economies of scale caused by the NBN, as discussed in chapter 4.

In relation to the 12 asset classes where Analysys Mason has made specific recommendations, the ACCC positions for this further draft decision are as follows:

- *CA01: Ducts and pipes* – the ACCC considers that Analysys Mason’s recommendations to scale down fixed line use of ducts and pipes in NBN FTTP/dp and HFC areas in line with the NBN rollout are appropriate. The ACCC considers these changes are necessary to ensure that use of ducts and pipes by relevant services during and following the NBN rollout in FTTP/dp and HFC areas is appropriately reflected. It also considers that these changes are required for consistency with the ACCC’s position of removing copper cables from the RAB as asset disposals in FTTP/dp and HFC areas. The ACCC also proposes to reduce fixed line use in FTTP/dp and HFC areas by the [c-i-c starts] [c-i-c ends] ratio to FTTP/dp and HFC rollout, as recommended by Analysys Mason. The ACCC considers that this adjustment will result in more appropriate measures of duct usage by the NBN compared to the fixed line network.
- *CA08: Network land and CA09: Network buildings and support* – Analysys Mason has recommended that land value modifications be adopted to achieve consistency with the corresponding asset classes in the core access network (CO08 and CO09). The ACCC considers that this modification is likely to provide a better representation of the value

³¹⁶ *ibid*, pp. 50-51.

of these assets used in different areas by various services. Given the information is available to make this adjustment and will result in a more accurate measure of use, the ACCC considers that the adjustment should be made where possible.

- *CO01: Local switching equipment* – The ACCC agrees with Analysys Mason’s recommended change in the split between port driven and traffic driven local switching equipment, as the asset register item identified by Analysys Mason does not appear to be attributable to either port driven or traffic driven equipment. The ACCC agrees in principle with removing the port/traffic distinction in the cost allocation framework if port driven assets are removed from the RAB as the NBN is rolled out. However, given this process will be gradual and port driven assets will remain in use over the regulatory period, the ACCC considers the port/traffic distinction should be retained.
- *CO02: Switching equipment (trunk) and CO03: Switching equipment (other)* – the ACCC agrees with Analysys Mason about Telstra’s use of trunk and other switching equipment for NBN-based voice services. The ACCC agrees that maintaining a more stable (pre-NBN) forecasts of traffic could better reflect how these assets are likely to be used over the regulatory period. However, since the ACCC will apply a loss of economies of scale adjustment for this asset class (an alternative method suggested by Analysys Mason for these asset classes) the ACCC considers it appropriate to maintain Telstra’s forecasts as proposed.
- *CO04: Inter-exchange cables* – the ACCC notes Analysys Mason’s recommendation to update platform allocations for this asset class to reflect updated information from March 2015. Although inter-exchange cables is a material asset class, the ACCC notes that only a small proportion is allocated to fixed line services. The ACCC considers that the inclusion of one additional data point to determine platform allocations will not result in a material change to the proportion of costs allocated to declared fixed line services. As such, the ACCC proposes to adopt the platform allocations for this asset class as proposed by Telstra.
- *CO05: Transmission equipment* – the ACCC proposes to adopt Analysys Mason’s recommendations to keep the platform allocation to ‘other’ transmission equipment constant at current levels over the regulatory period. The ACCC agrees that the proportion of other transmission equipment is not likely to increase significantly over the regulatory period considering its role in supporting the primary PDH, SDH and WDM transmission platforms.
- *CO07: Other communications plant and equipment, CO08: Network land, CO09: Network buildings and support* – the ACCC agrees with Analysys Mason’s recommendation to maintain TEBA demand forecasts at current levels. The ACCC considers that it is reasonable to assume no change in access seeker demand for rack space over the regulatory period in light of constant forecasts for Telstra racks.
- *CO12: Data equipment* – the ACCC does not propose to distinguish between scalable and non-scalable data equipment. Although there is likely to be certain data equipment that will be more responsive to changes in demand than others, the ACCC does not consider there is sufficient information available to make this distinction. In the absence of this information, the ACCC will treat data equipment as assets that become progressively more redundant as the migration to the NBN continues.

A Appendix A: Relevant legislative framework for final access determinations

This section sets out the relevant legislative framework in relation to final access determinations (FADs).

A.1 Content of final access determinations

Section 152BC of the CCA specifies what an FAD may contain. It includes, among other things, terms and conditions on which a carrier or carriage service provider (CSP) is to comply with the SAOs and terms and conditions of access to a declared service.

An FAD may make different provisions with respect to different access providers or access seekers.³¹⁷

A.2 Fixed principles provisions

An FAD may contain a fixed principles provision, which allows a provision in an FAD to have an expiry date after the expiry date of the FAD.³¹⁸ Such a provision allows the ACCC to 'lock-in' a term so that it would be consistent across consecutive FADs.

A.3 Varying final access determinations

Section 152BCN allows the ACCC to vary or revoke an FAD, provided that certain procedures are followed.

A fixed principles provision cannot be varied or removed unless the FAD sets out the circumstances in which the provision can be varied or removed, and those circumstances are present.³¹⁹

A.4 Commencement and expiry provisions

Section 152BCF of the CCA sets out the commencement and expiry rules for FADs.

An FAD must have an expiry date, which should align with the expiry of the declaration for that service unless there are circumstances that warrant a different expiry date.³²⁰

A.5 Matters to consider when making FADs

The ACCC must have regard to the matters specified in subsection 152BCA(1) of the CCA when making an FAD. These matters are:

- (a) whether the determination will promote the LTIE of carriage services or services supplied by means of carriage services
- (b) the legitimate business interests of a carrier or CSP who supplies, or is capable of supplying, the declared service, and the carrier's or provider's investment in facilities used to supply the declared service
- (c) the interests of all persons who have rights to use the declared service

³¹⁷ Subsection 152BC(5) of the CCA.

³¹⁸ Section 152BCD of the CCA.

³¹⁹ Subsection 152BCN(4) of the CCA.

³²⁰ Subsection 152BCF(6) of the CCA.

- (d) the direct costs of providing access to the declared service
- (e) the value to a person of extensions, or enhancement of capability, whose cost is borne by someone else
- (f) the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility, and
- (g) the economically efficient operation of a carriage service, a telecommunications network or a facility.

The subsection 152BCA(1) matters reflect the repealed subsection 152CR(1) matters that the ACCC was required to take into account in making a final determination (FD) in an access dispute. The ACCC interprets the subsection 152BCA(1) matters in a similar manner to the approach taken in access disputes.

Subsection 152BCA(2) sets out other matters that the ACCC may take into account in making FADs in certain circumstances.

Subsection 152BCA(3) allows the ACCC to take into account any other matters that it thinks are relevant.

The ACCC's views on how the matters in section 152BCA should be interpreted for the FAD process are set out below.

A.5.1 Paragraph 152BCA(1)(a)

The first matter for the ACCC to consider when making an FAD is 'whether the determination will promote the long-term interests of end-users of carriage services or of services supplied by means of carriage services'.

The ACCC has published a guideline explaining what it understands by the phrase 'long-term interests of end-users' in the context of its declaration responsibilities.³²¹ This approach to the LTIE was also used by the ACCC in making determinations in access disputes. The ACCC considers that the same interpretation is appropriate for making FADs for the declared fixed line services.

In the ACCC's view, particular terms and conditions promote the interests of end users if they are likely to contribute towards the provision of:

- goods and services at lower prices
- goods and services of a high quality, and/or
- a greater diversity of goods and services.³²²

The ACCC also notes that the Australian Competition Tribunal (Tribunal) has offered guidance in its interpretation of the phrase 'long-term interests of end-users' (in the context of access to subscription television services):

Having regard to the legislation, as well as the guidance provided by the Explanatory Memorandum, it is necessary to take the following matters into account when applying the touchstone – the long-term interests of end-users:

* End-users: "end-users" include actual and potential [users of the service]...

* Interests: the interests of the 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. ...[T]his would include access to innovations ... in a quicker timeframe than would otherwise be the case ...

³²¹ ACCC, Telecommunications services – declaration provisions: a guide to the declaration provisions of Part XIC of the Trade Practices Act, July 1999, in particular pp. 31–38.

³²² *ibid.*, p. 33.

* Long-term: the long-term will be the period over which the full effects of the ... decision will be felt. This means some years, being sufficient time for all players (being existing and potential competitors at the various functional stages of the ... industry) to adjust to the outcome, make investment decisions and implement growth – as well as entry and/or exit – strategies.³²³

To consider the likely impact of particular terms and conditions on the LTIE, the CCA requires the ACCC to have regard to whether the terms and conditions are likely to result in:

- promoting competition in markets for carriage services and services supplied by means of carriage services
- achieving any-to-any connectivity, and
- encouraging the economically efficient use of, and economically efficient investment in:
 - the infrastructure by which listed carriage services are supplied, and
 - any other infrastructure by which listed services are, or are likely to become, capable of being supplied.³²⁴

Promoting competition

In assessing whether particular terms and conditions will promote competition, the ACCC analyses the relevant markets in which the declared services are supplied (retail and wholesale) and considers whether the terms set in those markets remove obstacles to end-users gaining access to telephony and broadband services.³²⁵

Obstacles to accessing these services include the price, quality and availability of the services and the ability of competing providers to provide telephony and broadband services.

The ACCC is not required to precisely define the scope of the relevant markets in which the declared services are supplied. The ACCC considers that it is sufficient to broadly identify the scope of the relevant markets likely to be affected by the ACCC's regulatory decisions.

The ACCC's view is that the relevant markets for the purpose of making FADs for the declared fixed line services are:

- the market for the retail and wholesale supply of voice services (excluding Voice over Internet Protocol (VoIP) and mobile originated calls)
- the market for the retail and wholesale supply of broadband, and
- the market for the retail supply of a bundle of voice and broadband services.

Any-to-any connectivity

The CCA gives guidance on how the objective of any-to-any connectivity is achieved. It is achieved only if each end-user who is supplied with a carriage service that involves communication between end-users is able to communicate, by means of that service, with each

³²³ *Seven Network Limited (No 4)* [2004] ACompT 11 at [120].

³²⁴ Subsection 152AB(2) of the CCA.

³²⁵ Subsection 152AB(4) of the CCA. This approach is consistent with the approach adopted by the Tribunal in *Telstra Corporations Limited (No 3)* [2007] A CompT 3 at [92]; *Telstra Corporation Limited* [2006] A CompT at [97], [149].

other end-user who is supplied with the same service or a similar service. This must be the case whether or not the end-users are connected to the same telecommunications network.³²⁶

The ACCC considers that this matter is relevant to ensuring that the terms and conditions contained in FADs do not create obstacles for the achievement of any to any connectivity.

Efficient use of and investment in infrastructure

In determining the extent to which terms and conditions are likely to encourage the economically efficient use of and investment in infrastructure, the ACCC must have regard to:

- whether it is, or is likely to become, technically feasible for the services to be supplied and charged for, having regard to:
 - the technology that is in use, available or likely to become available
 - whether the costs involved in supplying and charging for, the services are reasonable or likely to become reasonable, and
 - the effects or likely effects that supplying and charging for the services would have on the operation or performance of telecommunications networks
- the legitimate commercial interests of the supplier or suppliers of the services, including the ability of the supplier or suppliers to exploit economies of scale and scope
- incentives for investment in the infrastructure by which services are supplied; and any other infrastructure (for example, the NBN) by which services are, or are likely to become, capable of being supplied, and
- the risks involved in making the investment.³²⁷

The objective of encouraging the 'economically efficient use of and economically efficient investment in ... infrastructure' requires an understanding of the concept of economic efficiency. Economic efficiency consists of three components:

- productive efficiency – this is achieved where individual firms produce the goods and services that they offer at least cost
- allocative efficiency – this is achieved where the prices of resources reflect their underlying costs so that resources are then allocated to their highest valued uses (i.e., those that provide the greatest benefit relative to costs), and
- dynamic efficiency – this reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities.

On the issue of efficient investment, the Tribunal has stated that:

An access charge should be one that just allows an access provider to recover the costs of efficient investment in the infrastructure necessary to provide the declared service.³²⁸

³²⁶ Subsection 152AB(8) of the CCA.

³²⁷ Subsections 152AB(6) and (7A) of the CCA.

³²⁸ Telstra Corporation Ltd (No. 3) [2007] ACompT 3 at [159].

...efficient investment by both access providers and access seekers would be expected to be encouraged in circumstances where access charges were set to ensure recovery of the efficient costs of investment (inclusive of a normal return on investment) by the access provider in the infrastructure necessary to provide the declared service.³²⁹

...access charges can create an incentive for access providers to seek productive and dynamic efficiencies if access charges are set having regard to the efficient costs of providing access to a declared service.³³⁰

A.5.2 Paragraph 152BCA(1)(b)

The second matter requires the ACCC to consider 'the legitimate business interests' of the carrier or CSP when making an FAD.

In the context of access disputes, the ACCC considered that it was in the access provider's legitimate business interests to earn a normal commercial return on its investment.³³¹ The ACCC is of the view that the concept of 'legitimate business interests' in relation to FADs should be interpreted in a similar manner, consistent with the phrase 'legitimate commercial interests' used elsewhere in Part XIC of the CCA.

For completeness, the ACCC notes that it would be in the access provider's legitimate business interests to seek to recover its costs as well as a normal commercial return on investment having regard to the relevant risk involved. However, an access price should not be inflated to recover any profits the access provider (or any other party) may lose in a dependent market as a result of the provision of access.³³²

The Tribunal has taken a similar view of the expression 'legitimate business interests'.³³³

A.5.3 Paragraph 152BCA(1)(c)

The third matter requires the ACCC to consider 'the interests of all persons who have the right to use the service' when making an FAD.

The ACCC considers that this matter requires it to have regard to the interests of access seekers. The Tribunal has also taken this approach.³³⁴ The access seekers' interests would not be served by higher access prices to declared services, as it would inhibit their ability to compete with the access provider in the provision of retail services.³³⁵

People who have rights to currently use a declared service will generally use that service as an input to supply carriage services, or a service supplied by means of carriage service, to end-users.

The ACCC considers that this class of persons has an interest in being able to compete for the custom of end-users on the basis of their relative merits. This could be prevented from occurring if terms and conditions of access favour one or more service providers over others, thereby distorting the competitive process.³³⁶

³²⁹ *ibid.* at [164].

³³⁰ *ibid.*

³³¹ ACCC, *Resolution of telecommunications access disputes – a guide*, March 2004 (revised) (Access Dispute Guidelines), p. 56.

³³² ACCC, *Access pricing principles—telecommunications*, July 1997 (1997 Access Pricing Principles), p. 9.

³³³ Telstra Corporation Limited [2006] ACompT 4 at [89].

³³⁴ Telstra Corporation Limited [2006] ACompT 4 at [91].

³³⁵ *ibid.*

³³⁶ *ibid.*

However, the ACCC does not consider that this matter calls for consideration to be given to the interests of the users of these 'downstream' services. The interests of end users will already be considered under other matters.

A.5.4 Paragraph 152BCA(1)(d)

The fourth matter requires the ACCC to consider 'the direct costs of providing access to the declared service' when making an FAD.

The ACCC considers that the direct costs of providing access to a declared service are those incurred (or caused) by the provision of access.

The ACCC interprets this matter, and the use of the term 'direct costs', as allowing consideration to be given to a contribution to indirect costs. This is consistent with the Tribunal's approach in an undertaking decision.³³⁷ A contribution to indirect costs can also be supported by other matters.

However, the matter does not extend to compensation for loss of any 'monopoly profit' that occurs as a result of increased competition.³³⁸

The ACCC also notes that the Tribunal (in another undertaking decision) considered the direct costs matter 'is concerned with ensuring that the costs of providing the service are recovered.'³³⁹ The Tribunal has also noted that the direct costs could conceivably be allocated (and hence recovered) in a number of ways and that adopting any of those approaches would be consistent with this matter.³⁴⁰

A.5.5 Paragraph 152BCA(1)(e)

The fifth matter requires that the ACCC consider 'the value to a party of extensions, or enhancements of capability, whose cost is borne by someone else' when making an FAD.

In the 1997 Access Pricing Principles, the ACCC stated that this matter:

...requires that if an access seeker enhances the facility to provide the required services, the access provider should not attempt to recover for themselves any costs related to this enhancement. Equally, if the access provider must enhance the facility to provide the service, it is legitimate for the access provider to incorporate some proportion of the cost of doing so in the access price.³⁴¹

The ACCC considers that this application of paragraph 152BCA(1)(e) is relevant to making FADs.

A.5.6 Paragraph 152BCA(1)(f)

The sixth matter requires the ACCC to consider 'the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility' when making an FAD.

The ACCC considers that this matter requires that terms of access should not compromise the safety or reliability of carriage services and associated networks or facilities, and that this has direct relevance when specifying technical requirements or standards to be followed.

³³⁷ Application by Optus Mobile Pty Limited and Optus Networks Pty Limited [2006] ACompT 8 at [137].

³³⁸ See Explanatory Memorandum for the *Trade Practices Amendment (Telecommunications) Bill 1996*, p. 44: [T]he 'direct' costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of increased competition in an upstream or downstream market.

³³⁹ Telstra Corporation Limited [2006] ACompT 4 at [92].

³⁴⁰ *ibid.* at [139].

³⁴¹ ACCC, 1997 Access Pricing Principles, p. 11.

The ACCC has previously stated in the context of model non-price terms and conditions, it is of the view that:

...this consideration supports the view that model terms and conditions should reflect the safe and reliable operation of a carriage service, telecommunications network or facility. For instance, the model non-price terms and conditions should not require work practices that would be likely to compromise safety or reliability.³⁴²

The ACCC considers that these views will apply in relation to paragraph 152BCA(1)(f) for the making of FADs.

A.5.7 Paragraph 152BCA(1)(g)

The final matter of subsection 152BCA(1) requires the ACCC to consider 'the economically efficient operation of a carriage service, a telecommunications network facility or a facility' when making an FAD.

The ACCC noted in the Access Dispute Guidelines (in the context of arbitrations) that the phrase 'economically efficient operation' embodies the concept of economic efficiency as discussed earlier under the LTIE. That is, it calls for a consideration of productive, allocative and dynamic efficiency. The Access Dispute Guidelines also note that in the context of a determination, the ACCC may consider whether particular terms and conditions enable a carriage service, telecommunications network or facility to be operated efficiently.³⁴³

Consistent with the approach adopted by the Tribunal, the ACCC considers that in applying this matter, it is relevant to consider the economically efficient operation of:

- retail services provided by access seekers using the access provider's services or by the access provider in competition with those access seekers, and
- the telecommunications networks and infrastructure used to supply these services.³⁴⁴

A.5.8 Subsection 152BCA(2)

Subsection 152BCA(2) provides that, in making an AD that applies to a carrier or CSP who supplies, or is capable of supplying, the declared services, the ACCC may, if the carrier or provider supplies one or more eligible services,³⁴⁵ take into account:

- the characteristics of those other eligible services
- the costs associated with those other eligible services
- the revenues associated with those other eligible services, and
- the demand for those other eligible services.

The Explanatory Memorandum states that this provision is intended to ensure that the ACCC, in making an AD, does not consider the declared service in isolation, but also considers other relevant services.³⁴⁶ As an example, the Explanatory Memorandum states:

³⁴² ACCC, Final Determination – Model Non-price Terms and Conditions, November 2008, p. 8.

³⁴³ ACCC, Access Dispute Guidelines, p. 57.

³⁴⁴ *Telstra Corporation Limited* [2006] ACompT at [94]–[95].

³⁴⁵ 'Eligible service' has the same meaning as in section 152AL of the CCA.

³⁴⁶ Explanatory Memorandum, Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2010, p. 178.

...when specifying the access price for a declared service which is supplied by an access provider over a particular network or facility, the ACCC can take into account not only the access provider's costs and revenues associated with the declared service, but also the costs and revenues associated with other services supplied over that network or facility.³⁴⁷

The ACCC proposes to consider the costs and revenues associated with other services—whether declared or not declared—that are provided over Telstra's network when making FADs for the declared fixed line services.

A.5.9 Subsection 152BCA(3)

This subsection states the ACCC may take into account any other matters that it thinks are relevant when making an FAD.

The ACCC is of the view that considerations of regulatory certainty and consistency will be important when setting the terms and conditions of the FADs.

The ACCC also considers that it should have regard to:

- its previous decisions in relation to the fixed line services (both arbitrations and access determinations)
- consultation documents and submissions in response to those documents
- information provided to the ACCC by Telstra under RKR.

These considerations and documents do not limit the matters that the ACCC may have regard to when making the FADs for the declared fixed line services.

³⁴⁷ *ibid.*

B Appendix B: Summary of submissions

Telstra submission documentation

Telstra, <i>Final Access Determinations (FADs) Inquiry – additional information in response to information request under the BBM RKR</i> , February 2014.
Telstra, <i>Cost Allocation Framework for the ACCC Fixed Line Services Model</i> , Version 1.3, June 2015.
Telstra, <i>Cost Allocation Framework for the ACCC Fixed Line Services Model - Framework and Model Guide</i> , Version 1, July 2014.
Telstra, <i>Forecast Model v 1.05 Framework and Guide to Forecast Assumptions</i> , October 2014.
Telstra, <i>Fixed Services Forecast Model</i> , v1.1, Jan2015.
Telstra, <i>Public inquiry into final access determinations for fixed line services – primary prices (confidential version)</i> , 12 March 2015.
Telstra, <i>Public inquiry into final access determinations for fixed line services – primary prices, Response to Draft Decision</i> , 1 May 2015.
Telstra, <i>Fixed Services Forecast Model</i> , v1.2, May 2015.

Telstra responses to requests for information

Telstra, <i>Fixed Line Services final access determination inquiry: ACCC request for information</i> , 30 January 2015.
Telstra, <i>Amendments to the Fixed Line Services Model</i> , 6 February 2015.
Telstra, <i>Calculating the FLSM share of Operations Business Unit Support – Deriving a Mark-up ratio</i> , 23 February 2015.
Telstra, <i>Further explanation of FY2014 operating costs identified as relevant to the FLSM</i> , March 2015.
Telstra, <i>Fixed line services final access determination inquiry: ACCC request for information</i> , 5 March 2015.
NERA, <i>The Comparative Efficiency of Telstra: A Report for Telstra</i> , April 2015.
KPMG, <i>Gilbert and Tobin, The basis for determining Telstra's base year operating expenditure for fixed line services</i> , April 2015.
Keith Lockey, <i>The basis of accounting for disposals of assets in Telstra's regulatory asset base for fixed line services</i> , April 2015.
Jeff Balchin, <i>Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services</i> , April 2015.
[c-i-c start] [REDACTED] [c-i-c end]

[c-i-c start] [REDACTED] [c-i-c end]

Other stakeholders

Frontier Economics, *Submission on the ACCC's draft decision on fixed line prices, A Report Prepared For the Competitive Carriers Coalition, iiNet and Optus*, May 2015.

Optus, *Submission in response to ACCC Draft Decision, Public Inquiry into final access determinations for fixed line services – primary price terms*, April 2015.

iiNet, *Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision*, March 2015.

C Appendix C: Fixed principles provisions

C.1 Introduction

The ACCC set fixed principles provisions in the 2011 fixed line services FADs. These fixed principle provisions were updated in the 2013 Wholesale ADSL FAD to reflect the inclusion in the regulatory asset base (RAB) of assets used to supply that service and not included in the RAB at the time of the 2011 FADs.

The ACCC draft decision does not include any amendments to the fixed principles provisions it made for the 2011 and 2013 FADs. The fixed principles provisions included in the 2013 Wholesale ADSL FAD are reproduced below.

C.2 Fixed principles provisions

- 6.1 This clause 6 sets out fixed principles provisions that apply to the FAD contained in this document.
- 6.2 The FAD contained in this document must not be varied so as to alter or remove any of the fixed principles provisions in this clause 6 except when the ACCC is satisfied that:
- (a) there is a manifest and material error in these fixed principles provisions;
 - (b) any information on which these fixed principles provisions was based was false or misleading in a material respect; or
 - (c) such amendment or adjustment is necessary or desirable to avoid an unintended consequence of these fixed principles provisions.
- 6.3A The below fixed principles provisions come into force in relation to the Wholesale ADSL service on 29 May 2013.
- 6.4 The nominal termination date for the fixed principles provisions is 30 June 2021.
- 6.5A The opening regulatory asset base (RAB) for the calculation of prices for the Wholesale ADSL service is:
- (a) as per clause 6.5 of the FADs dated 20 July 2011 (as varied from time to time), rolled forward to 1 July 2012 in accordance with clause 6.7 of the FADs dated 20 July 2011; and
 - (b) the asset class data equipment which is \$1,094,008,824 as at 1 July 2012 (in nominal terms).
- 6.6A The opening tax asset value for the calculation of prices for the Wholesale ADSL service is:
- (a) as per clause 6.6 of the FADs dated 20 July 2011 (as varied from time to time), rolled forward to 1 July 2012 in accordance with clause 6.7 of the FADs dated 20 July 2011; and
 - (b) the asset class data equipment which is \$1,086,735,207 as at 1 July 2012 (in nominal terms).
- 6.7 Roll-forward mechanism
- (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

- (b) Land asset values will be indexed by the Consumer Price Index (CPI) where it is available or by the forecast for the CPI used in the Fixed Line Services Model (FLSM) where actual CPI is not available. This will account for appreciation over time in land values.
- (c) To roll forward RAB values in nominal terms, any variables that are specified in real terms will be indexed by the actual CPI where it is available or by the forecast for the CPI used in the FLSM where the actual CPI is not available.
- (d) Any variables that are specified in nominal terms will not be indexed, with the exception of land values as specified above.
- (e) In these fixed principles provisions 'the FLSM' means the FLSM as it may be varied from time to time or similar model used by the ACCC for the calculation of prices for the relevant declared services.

6.8 The annual revenue requirement for each regulatory period will comprise:

- (a) a return on the RAB calculated by multiplying the Weighted Average Cost of Capital (WACC) by the opening RAB for the regulatory year;
- (b) a return of the RAB, that is regulatory depreciation, for that regulatory year;
- (c) operating expenditure forecast to be incurred in that regulatory year; and
- (d) an allowance for tax liabilities.

6.9 Under a building block model (BBM) approach, forecast operating expenditures should reflect prudent and efficient costs. The following matters are relevant to whether forecast operating expenditures reflect prudent and efficient costs:

- (a) the access provider's level of operating expenditure in the previous regulatory period;
- (b) reasons for proposed changes to operating expenditure from one regulatory period to the next regulatory period;
- (c) any relevant regulatory obligations, or changes to such obligations, applicable to providing the relevant declared fixed line services; and
- (d) any other matters relevant to whether forecast operating expenditures reflect prudent and efficient costs.

6.10 Under a BBM approach, forecast capital expenditures should reflect prudent and efficient costs. The following matters are relevant to whether capital expenditure forecasts reflect prudent and efficient costs:

- (a) the access provider's level of capital expenditure in the previous regulatory period;
- (b) reasons for proposed changes to capital expenditure from one regulatory period to the next regulatory period;

- (c) whether the access provider's asset management and planning framework reflects best practice;
- (d) any relevant regulatory obligations, or changes to such obligations, applicable to providing the relevant declared fixed line services; and
- (e) any other matters relevant to whether forecast capital expenditures reflect prudent and efficient costs.

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.

6.12 Weighted average cost of capital

- (a) A vanilla WACC is used to estimate the return on capital.
- (b) The cost of equity is estimated using the Capital Asset Pricing Model.

6.13 Tax liabilities

- (a) The tax rate used in estimating tax liabilities in the FLSM will be set equal to the corporate tax rate specified in subsection 23(2) of the *Income Tax Rates Act 1986* (Cth) as amended from time to time.

6.14 Cost allocation factors

- (a) The allocation of the costs of operating the PSTN should reflect the relative usage of the network by various services.
- (b) Direct costs should be attributed to the service to which they relate.
The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.
- (c) No cost should be allocated more than once to any service
- (d) The determination of cost allocation factors should reflect the principles in 6.14 (a) – (c) above except where reliable information is not available to support the application of the principles.

6.15 The matters set out in the fixed principles provisions at clauses 6.7 – 6.14 inclusive are subject to assessment, calculation, implementation and/or application, as relevant, by the ACCC in making interim and final access determinations for the relevant declared services.

D Appendix D: Description of the declared fixed line services

The following are service descriptions to the seven declared fixed line services. Declaration to ULLS, LSS, WLR, LCS, FOAS and FTAS took effect on 1 August 2014 and expires on 31 July 2019.³⁴⁸ Declaration to wholesale ADSL took effect on 14 February 2012 and expires on 13 February 2017.³⁴⁹

More information on service declarations are available from the ACCC's website www.accc.gov.au.

D.1 Unconditioned local loop service

The unconditioned local loop service is the use of unconditioned communications wire between the boundary of a telecommunications network at an end-user's premises and a point on a telecommunications network that is a potential point of interconnection located at or associated with a customer access module and located on the end-user side of the customer access module.

D.2 Line sharing service

The line sharing service is the use of the non-voiceband frequency spectrum of unconditioned communications wire (over which wire an underlying voiceband PSTN service is operating) between the boundary of a telecommunications network at an end-user's premises and a point on a telecommunications network that is a potential point of interconnection located at, or associated with, a customer access module and located on the end-user side of the customer access module.

D.3 Wholesale line rental

The wholesale line rental service is a line rental telephone service which allows an end-user to connect to a carrier or carriage service provider's public switched telephone network, and provides the end-user with:

- (a) an ability to make and receive any 3.1kHz bandwidth calls (subject to any conditions that might apply to particular types of calls), including, but not limited to, local calls, national and international long distance calls; and
- (b) a telephone number

however, the wholesale line rental service does not include services where the connectivity between the end-user and the carrier or carriage service provider's network is provided in whole or in part by means of a Layer 2 bitstream service that is supplied by an NBN corporation.

D.4 Local carriage service

The local carriage service is a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone, however, the local carriage service does not include services where the connectivity between the end-user and the carrier or carriage service provider's

³⁴⁸ ACCC, Public Inquiry into the fixed line services declarations, Final Report, April 2014, pp 66-79.

³⁴⁹ ACCC, Declaration under section 152AL(3) of the Competition and Consumer Act 2010, Wholesale ADSL service declaration.

network is provided in whole or in part by means of a Layer 2 bitstream service that is supplied by an NBN corporation.

D.5 Fixed originating access service

(The fixed originating access service is) an access service for the carriage of telephone calls (i.e. voice, data over the voice band) to a Point of Interconnect (POI) from end-customers assigned numbers from the geographic number ranges of the Australian Numbering Plan and directly connected to the access provider's network.

For the avoidance of doubt, the service also includes a service for the carriage of telephone calls from customer equipment at an end-user's premises to a POI, or potential POI, located at or associated with a local switch (being the switch closest to the end-user making the telephone call) and located on the outgoing trunk side of the switch.

D.6 Fixed terminating access service

(The fixed terminating access service) is an access service for the carriage of telephone calls (i.e. voice, data over the voice band) from a POI to end-customer assigned numbers from the geographic number ranges of the Australian Numbering Plan and directly connected to the access provider's network.

For the avoidance of doubt, the service also includes a service for the carriage of telephone calls from a POI, or potential POI, located at or associated with a local switch and located on the incoming trunk side of the switch to customer equipment at an end-user's premises.

D.7 Wholesale asymmetric digital subscriber line

The wholesale asymmetric digital subscriber line service is an internet-grade, best efforts point to point service for the carriage of communications in digital form between a point of interconnection and an end-user network boundary that:³⁵⁰

- (a) is supplied by means of Asymmetric Digital Subscriber Line (ADSL) technology over a twisted metallic pair that runs from the end-user network boundary to the nearest upstream exchange or remote integrated multiplexer or customer multiplexer; and
- (b) uses a static layer 2 tunnelling protocol (L2TP) over a transport layer to aggregate communications to the point of interconnection.

³⁵⁰ ACCC, Declaration of the wholesale ADSL service, Final decision, February 2012, p 60.