TELSTRA CORPORATION LIMITED

PUBLIC INQUIRY TO MAKE FINAL ACCESS DETERMINATIONS FOR THE DECLARED FIXED LINE SERVICES

EXECUTIVE SUMMARY OF TELSTRA'S RESPONSE TO THE COMMISSION'S DISCUSSION PAPER

3 June 2011

TABLE OF CONTENTS

1. INTRODUCTION

1 Telstra welcomes the opportunity to respond to the Australian Competition and Consumer Commission's (**Commission**) *Public inquiry to make Final Access Determinations for the Declared Fixed Line Services - Discussion Paper* dated April 2011 (**Discussion Paper**).

2 The first section of this submission sets out Telstra's executive summary of its submissions in response to the Discussion Paper.

3 The second section of this submission sets out the structure of Telstra's submissions.

2. EXECUTIVE SUMMARY

2.1. PRICE ISSUES

4 Telstra, like the Commission, seeks early resolution of outstanding issues, and is looking forward to reaching regulatory certainty on a range of issues that are critical to the industry's future.

5 Telstra, however, has some fundamental concerns about certain aspects of the Commission's approach. These concerns are not new: the issues they address have been well covered in past submissions and flagged in discussions with the Commission since the Discussion Paper was issued. However, it is evident in the draft final access determinations (**FADs**) that the Commission's reasoning does not adequately deal with these issues.

6 Telstra has five major concerns in relation to the price terms of the draft FADs:

2.1.1. THE SETTING OF THE INITIAL REGULATORY ASSET BASE

7 Telstra has a legitimate business interest in recovering the economic value of its fixed line investments. The purpose of the Commission's inquiry should be to establish an initial regulatory asset base (**RAB**) valuation which reflects that economic value. As previously submitted, in order to provide for this the initial RAB should properly be based on a depreciated optimised replacement cost (**DORC**) valuation of Telstra's Customer Access Network (**CAN**) and Inter Exchange Network (**IEN**) assets. Telstra has put forward a DORC valuation based on the remaining value of its assets as at the conclusion of the previous pricing regime, which has not been properly considered in the Discussion Paper.

8 The Commission has also failed to properly consider the alternative valuation put forward by Telstra based on indexed historic cost, rejecting it on the basis of incorrect assumptions about the past treatment of inflation.

9 Instead, the Commission has used written down accounting values as a floor for valuation, on the basis that this will provide for recovery of Telstra's actual investment costs, plus a commercial return. However, as has previously been demonstrated by Telstra, the regulatory accounts relied on by the Commission overstate past allowed depreciation expenses, and therefore significantly understate remaining value. In the Discussion Paper the Commission acknowledges that written down accounting values are likely to understate the remaining asset value, but erroneously and without evidence concludes that this will have been outweighed by over-recovery on older assets.

10 Further, the Commission has adopted an idiosyncratic approach to selecting a value above its DAC floor. It has set this value based on one consideration alone – a $16 ULLS price – which it has chosen to perpetuate for Band 2 areas and extend to Bands 1 and 3.

11 This raises three problems: first, the arbitrary nature of selecting and extending a $16 price as an input to, rather than an output of, a cost model; second whether $16 would be the right input in any event, when that figure was part of a (rising) price path set by previous regulatory decisions; and third, whether the asset valuation and subsequent prices for non

ULLS services can be said to be properly set by reference to an arbitrary input of that nature.

12 Telstra submits that, while there are obvious merits to ULLS price stability, it alone cannot be the determining factor in setting values. Rather, stability and consistency with past decisions is only properly achieved (and can in fact be achieved) by applying consistent and appropriate asset values through the transition from one regulatory pricing regime to another.

2.1.2. ALLOCATION OF COSTS

13 The Commission's fixed line services model (**FLSM**) also, problematically, allocates costs to services that are no longer produced or purchased. The Commission assumes that total demand for services in operation (**SIOs**) and call minutes are held constant over time. For call minutes, the Commission uses peak level of demand from 2002/2003 and for SIOs, the Commission uses the level of demand from 2009/2010 to derive constant unit costs for the relevant asset categories. This has the effect of allocating costs to lines and minutes that no longer exist. This is inconsistent with the Commission's previous approach to cost allocation and is out of step with what other regulators do (for example, the Australian Energy Regulator).

14 As a result, under the Commission's approach Telstra can never recover the value of its investments (even at the reduced value set by the Commission), or its future capital and operating expenditure. The hotel analogy by which the Commission justifies this approach – that Telstra's network is like a hotel that was built with more rooms than are now needed – is irrelevant and does not, in fact, support the Commission's approach. In competitive markets, hotels are often not fully occupied, yet are able to charge their guests enough to cover their total costs, including the cost of the empty rooms. If they could not, investments already made in hotels would be stranded and new investment would fall away rapidly. It is also incorrect for the Commission to state that Telstra's business risks are adequately compensated in the weighted average cost of capital (**WACC**).

15 Critically, the Commission's approach to cost allocation in the FLSM is inconsistent with the Commission's previous approach, the approaches of other regulators and the statutory criteria.

2.1.3. OTHER COSTS ARE NOT PROPERLY REFLECTED IN THE COMMISSION'S COST MODEL.

16 Most importantly, the cost of capital is understated. The equity beta fails to reflect the commercial risks Telstra faces; the debt risk premium is over-simplified and out of line with previous approaches, and the gamma is overstated and requires updating in order to align with recent decisions.

17 Tax expenses are calculated on the basis of accounting asset values, but should be calculated on tax asset values; and there are several other computational issues in the FLSM that require correction.

2.1.4. COSTS ARE NOT PROPERLY CONVERTED INTO PRICES

18 The draft FADs propose the setting of a nationally averaged price for PSTN originating and terminating access (**PSTN OTA**), rather than the longstanding approach of geographically disaggregated pricing. The new price would be the current "headline rate" of 1c per minute (being the average of the geographically de-averaged prices).

19 This represents a significant price cut, because the geographic usage of PSTN OTA by Access Seekers is skewed towards high-cost areas (reflecting the fact that alternative networks and ULLS usage is focussed in higher-density / lower cost areas) and the average per minute price paid is 1.3c per minute. If a nationally averaged price is set, there can be no expectation that commercially negotiated de-averaging would occur. Telstra would face

cost under-recovery and a revenue shortfall, while Access Seekers would face distorted price signals and incentives to skew usage even further.

20 Telstra submits that geographically de-averaged prices should be retained. While the Commission has expressed reservations about the profile of cost relativities across geographic areas, Telstra provides further analysis (including that based on the Commission's own Analysys model) that addresses these concerns.

21 There are also problems with how weighted averages are calculated for wholesale line rental (**WLR**) prices, which are set in a way that yields a price that is lower than the average cost of lines. Unless corrected, this would provide incentives for inefficient investment, and impede cost recovery.

2.1.5. THE PROPOSED REGULATORY INSTRUMENTS FAIL TO PROVIDE CERTAINTY AND REQUIRE AMENDMENT

22 The draft FADs incorporate a set of fixed principles intended to deliver regulatory pricing certainty beyond the initial regulatory period. However, they fail to offer certainty in a number of key areas, including how the RAB would be "updated" between periods, how the WACC will be applied, how the annual revenue requirement will be calculated, and how asset lives and depreciation will be determined.

23 While the FLSM answers some of these questions, that of itself does not provide certainty unless those issues are also addressed in the fixed principles. Telstra has previously provided a comprehensive working proposal and specific drafting to address many of these matters, and maintains its view that more detailed fixed principles to clarify and codify the essential elements of the framework would be appropriate. In this submission, Telstra proposes the minimum amendments it considers necessary to provide regulatory certainty and reduce potential future disputation.

24 Telstra also considers that the FADs should provide that prices are exclusive of taxes, and that a reasonable amount can be charged to cover tax liabilities not recovered in the price.

25 Further, Telstra submits that the proposal to introduce record-keeping rules is inappropriate and unjustified.

26 The above price issues represent fundamental errors in the approach proposed by the Commission and in the draft FADs. With few exceptions (such as the fixed principles, which were only recently released), the issues canvassed in the Discussion Paper are not new, but are well understood and can be corrected expeditiously. (That said, should the FLSM or draft FADs alter materially in ways other than those addressed in this submission, Telstra would seek the opportunity to be heard on those changes.)

27 These price issues need to be addressed if the FADs are to comply with the statutory criteria. As it stands, the proposed approach would result in a fundamental revaluation of Telstra's fixed line investments, and a new building-block model which does not allow it to recover the appropriately allocated anticipated future costs of providing fixed line services, nor provide it an appropriate risk-adjusted return. This is at odds with regulatory precedent and the expert opinions of international regulatory economists, and would fail to meet the statutory criteria under which the access determinations are made, including because it fails to take account of Telstra's legitimate business interests, and it undermines investment incentives in a manner that is not in the long-term interests of end users.

28 Telstra urges the Commission to give meaningful consideration to its price submissions, and is available to work with the Commission to expeditiously resolve the outstanding issues.

2.2. NON-PRICE TERMS AND CONDITIONS

2.2.1. THE COMMISSION SHOULD NOT INCORPORATE THE MODEL TERMS INTO THE FADS

29 Telstra is concerned that the Commission is proposing to include in the FADs a number of terms and conditions from the Commission's *Model Non-Price Terms and Conditions* Determination, dated November 2008 (**Model Terms**). The Commission should not do so, given that the nature of the Model Terms and the FADs is entirely different.

30 The Model Terms are non-binding and were intended to be a useful starting point for parties in negotiating the terms and conditions of commercial agreements. Their non binding nature reflects that they were not intended to apply to all Access Providers and all Access Seekers in all circumstances.

31 The FADs, in contrast, are intended to be a binding set of terms applicable to Access Providers and Access Seekers where they cannot agree a set of commercial terms. This will be the case regardless of how inappropriate or unsuitable the terms may be.

32 Further, unlike some service-specific non-price terms which have been disputed by Access Seekers in the past, the more generic commercial terms in the Model Terms historically have not been a matter for dispute between the parties. Accordingly, incorporating these terms (such as billing and notifications) into the FADs is unnecessary.

33 Telstra requests that the Commission reconsider its proposed approach in this regard.

2.2.2. THE NON-PRICE TERMS AND CONDITIONS SHOULD BE CLEAR, BALANCED AND REASONABLE

34 If, however, the Commission is minded to incorporate the Model Terms into the FADs, Telstra proposes a number of amendments to, among other things, clarify the parties' rights. Such amendments are necessary in light of:

(a) the severe consequences for both Access Providers and Access Seekers if they breach the FADs, being a breach of an Access Provider's carrier licence conditions and a breach of the Access Seeker's service provider rules. There are potentially significant pecuniary penalties associated with doing so; and

(b) in order to avoid unnecessary disputes regarding the interpretation of various terms of the FADs, which is in the interests of both Access Providers and Access Seekers.

35 Further, the FADs should be balanced in their application to both Access Providers and Access Seekers. The FADs ensure that the interests of Access Seekers are protected. However, the FADs do not do so in respect of the principal obligation owed by Access Seekers to Access Providers, being their ability to pay (in a timely manner) for supply of the Services the subject of the FADs. Accordingly, Telstra proposes amendments in order to adequately protect Access Providers' financial exposure and risk.

36 In addition, the FADs should be consistent with commercial practice. This is because those practices reflect an efficient outcome resulting from balanced negotiations between the parties. Efficient outcomes should not be overturned by the Commission without a good reason for doing so.

2.2.3. THE FADS MUST BE WITHIN THE SCOPE OF THE COMMISSION'S POWERS

37 Telstra is concerned that some of the terms of the draft FADs (for example, clauses 9.1 and 9.5) would effectively require Access Providers to provide access to Access Seekers where there are reasonable grounds to believe that the Access Seeker would fail to comply with the relevant terms and conditions.

In addition, the FADs should not apply more broadly than their intended scope. That is, the FADs should apply to the six declared fixed line services, and only to the charges for those services which are set out in the FADs. Thus, Telstra proposes amendments to ensure that the FADs are within scope.

2.2.4. THE COMMISSION SHOULD NOT INCLUDE TERMS REGARDING IVULLS, LIABILITY OR FACILITIES ACCESS IN THE FADS

38 It would be unnecessary and inappropriate to include terms regarding iVULLS, liability or facilities access in the FADS. This is because, in respect of iVULLS, Telstra announced the launch of the Enhanced Vacant Unconditioned Local Loop (**eVULLS**) process which removes the requirement for a workforce appointment at an end user's premises. Given that four Access Seekers have already entered into agreements to use the eVULLS (and their customers constitute 87% of all current vacant ULLS connections), mandating an eVULLS process in the FADs is unnecessary.

39 Liability terms have never been the subject of a formal dispute between the parties and it is unnecessary for the Commission to intervene.

40 In respect of facilities access, a number of recent developments - including the improvement of Telstra's facilities access processes, the implementation of a "dual build" process and continuation of a "parallel build" process – supersede the Commission's previous facilities access terms. Again, in light of these developments, mandating facilities access provisions in the FADs is unnecessary,

41 If, however, the Commission remains minded to include terms in the FADs on the above three issues, the appropriate way of doing so is by way of variation to the FADs. That process should involve a comprehensive consultation, during which interested persons have an opportunity to provide specific comments on the proposed terms.

2.3. GEOGRAPHIC EXEMPTIONS

42 Telstra agrees with the Commission's preliminary view that the Exemption Determinations should be incorporated into the FADs for the WLR, LCS and PSTN OA services. The exemptions should expire on 30 June 2016.

43 The Australian Competition Tribunal's test for exemption is self-executing, the satisfaction of which is conclusive evidence that an exchange service area (**ESA**) is subject to sufficiently competitive conditions. The threshold test is conservative, and has three rigorous pre-conditions for exemption being:

(a) three or more ULLS competitors;

(b) those competitors having an aggregate market share of equal to or greater than 30%; and

(c) those competitors having aggregate spare capacity of equal to or greater than 40% of WLR SIOs in that ESA.

44 In actuality, the number of ULLS-based competitors in each exempt ESA is 5.4 - nearly double the Tribunal's threshold number.

45 The satisfaction of the threshold test indicates clear competitive constraint on Telstra's supply of WLR, LCS and PSTN OA such that the grant of the exemption would be consistent with the statutory criteria and promote regulatory certainty and consistency in relation to

price. This will lead to efficient investment and better offerings for end users in terms of price and service quality.

46 The roll-out of the NBN does not alter the rationale supporting copper-based investment and competition, nor will it effectively "strand" Access Seekers' investments in DSLAMs. Any assertions contrary to this are incorrect and unfounded. It is also incorrect for Access Seekers to claim that Telstra continuing to charge competitive commercial prices for WLR, LCS and PSTN OA in the 129 currently exempt ESAs demonstrates a lack of competition in those areas, or otherwise impacts the rationale for the incorporation of the exemptions into the FADs.

47 Further, the threshold test set out in Exemption Determinations in the FADs for WLR, LCS and PSTN OA should apply to all ESAs, rather than just the essentially arbitrary list of 380 ESAs the subject of the Tribunal's Metropolitan Orders. The threshold test is self-executing - if an ESA has three or more ULLS-based competitors, who together have 30% aggregate market share in an ESA and ULLS spare capacity greater than 40%, then there is no reason in principle that such an ESA should not become exempt.

2.4. NBN-BASED WHOLESALE SERVICES

48 The FADs should provide that the SAOs do not apply to Access Providers who supply WLR, LCS and PSTN OA over the NBN. This is because:

(a) Telstra will no longer be the owner and operator of the largest fixed line telecommunications network due to structural reform in the industry;

(b) without an exemption, there is a risk of a price squeeze on Telstra, as it may be compelled to supply NBN access services to Access Seekers at legacy rates;

(c) resale regulation will hinder competition in the wholesale markets for NBN-based access services; and

(d) resale regulation will deter or delay potential wholesalers of NBN-based access services from entering the market to compete and innovate in relation to wholesale services provided over NBN.

49 There is no need for a transition period before these exemptions come into effect.

3. STRUCTURE OF TELSTRA'S SUBMISSIONS

50 Telstra's submissions are structured as follows.

51 **Part A** sets out Telstra's concerns in relation to price terms and fixed principles in Part A and Part E of the Discussion Paper.

52 **Part B** sets out Telstra's response to the proposed non-price terms and conditions and Telstra's response to the proposed connection and disconnection charges in Part B and Part A (Section 15) of the Discussion Paper.

53 **Part C** deals with Telstra's response to the proposed geographic exemptions and the NBN-based wholesale services in Part C and Part D of the Discussion Paper.