



Submission on the ACCC's draft decision on fixed line prices

A REPORT PREPARED FOR THE COMPETITIVE CARRIERS
COALITION, IINET AND OPTUS

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Executive summary

Frontier Economics (Frontier) has been engaged by the Competitive Carriers' Coalition (CCC), iiNet and Optus to scrutinise the ACCC's draft decision¹ on the prices proposed for the declared fixed line services. This has included an accompanying report by the ACCC's economic consultants, WIK-Consult (WIK), on Telstra's cost forecasts.²

A careful reading of the draft decision and WIK's report leave the clear impression that the ACCC is in a difficult position. By the ACCC's own admission, its ability to make a draft decision has been compromised by a lack of information from Telstra, and the ACCC could not be satisfied that Telstra's costs are prudent and efficient. WIK has also raised a further raft of concerns about the adequacy of Telstra's information and its forecasting approaches. However, further delaying a decision would be undesirable. Even implementing only limited elements of WIK's proposed changes suggests that prices for the declared services should materially fall. Further, the current 'rolled over' prices are allowing over-recovery of the current year costs, so further delays will allow Telstra to 'lock in' the benefits of the over-recovery for longer. Making a final decision that balances the need for timely resolution with requirements for robust and stringent review of prudence and efficiency is consequently not straightforward.

Suggested approach

We recognise that the ACCC is faced with a situation where it must make a final decision based on imperfect information, but a path focused only on seeking further information is not a sustainable long-term response to this difficulty. We suggest four things:

- The ACCC should, at a minimum, implement recommendations by WIK that can be implemented now. We have shown below that it is possible to implement some recommendations immediately, without further information from Telstra.
- The ACCC should consider the feasibility of setting cost allowances independently of Telstra's forecasts, similar to the process of the AER, at the least to provide Telstra with better incentives to produce more transparent information.

¹ ACCC, *Public Inquiry into final access determinations for fixed line services – primary price terms: Draft Decision*,

² WIK-Consult, *Assessment on the efficiency and prudence of Telstra's expenditure forecasts*, March 2015. Referred to as "WIK report".

- In the meantime, the ACCC should seek further information from Telstra on the *base year* costs for opex and capex, and satisfy itself that costs have been appropriately allocated to RAB asset categories (and not double counted).
- Once the base year costs have been established, the ACCC should forecast the *aggregate* opex and capex forward in proportion to the changes in SIOs due to the NBN rollout. This would represent a ‘top-down’ approach to forecasting that would obviate the need to make a detailed, bottom-up assessment of changes in Telstra’s costs, which would be very information-intensive. Aligning the forecasts with the change in SIOs will reflect that the primary driver of cost changes will be the NBN rollout and will also ensure that access seekers are no worse off from the rollout, in line with WIK’s recommendations.

A material reduction in prices is justified

Even the limited analysis we have conducted, formed from our review of WIK’s recommendations and the use of top-down forecasts based on Telstra’s base year costs (2014-15), shows that:

- making a limited number of the changes proposed by WIK will lead to a significant reduction in prices
- applying a top down forecast that uses Telstra’s existing base year forecasts and is consistent with WIK’s overall approach to NBN related impacts (i.e. that Telstra should bear the costs of this) will result in an even larger reduction in prices.

We emphasise that this in no way accounts fully for all of WIK’s proposed improvements. Rather, we have attempted to make some of the more straightforward changes that are proposed, using existing data that was available to the ACCC at the time it made its draft decision. In reality, the full extent of the changes proposed by WIK would result in further price reductions, but it is impossible to determine the significance of these without further information.³

The following Figure highlights the changes to prices that we consider could be justified, at least on the basis of the material put before the ACCC at the draft decision. It highlights:

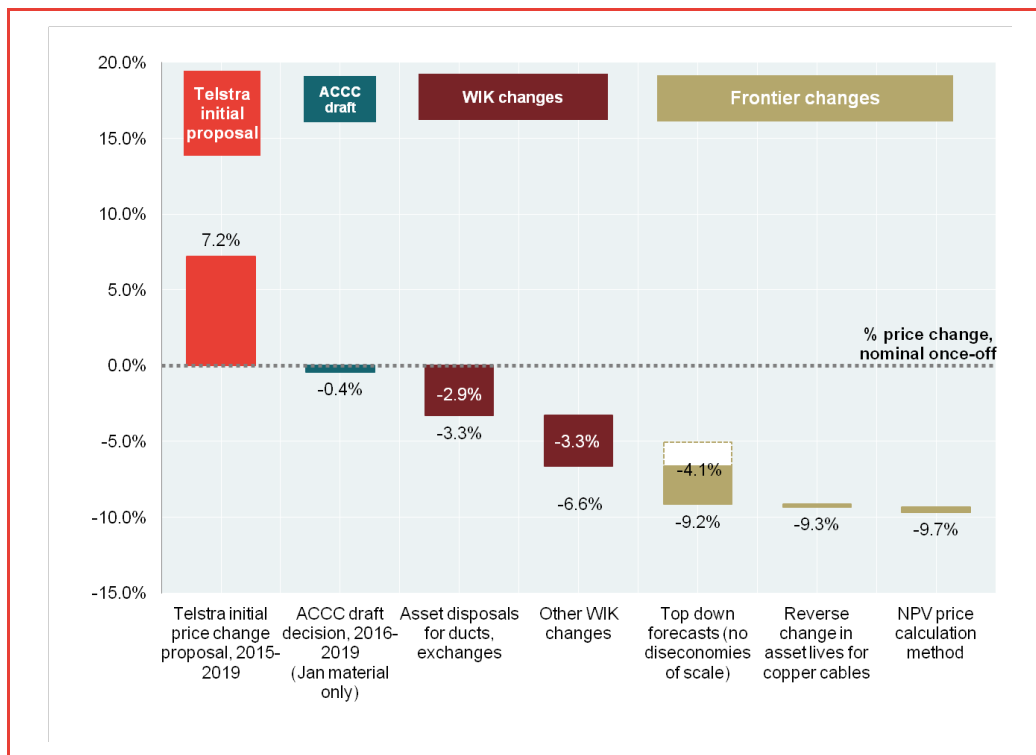
- Telstra’s original proposal of a 7.2% increase (later modified).
- The ACCC’s draft decision, which *inter alia* involves significant decreases as a result of removing NBN-related capex and propex, a lower WACC, and other more minor changes. We show -0.4% as the result in the Figure as we cannot fully reconcile the ACCC and Telstra models, as described in Box 1.

³ See Box 2 for a further discussion.

- Incorporating overcapacity of ducts, copper cables and pipes and exchanges as asset disposals
- Making other changes as proposed by WIK (a subset of its recommendations that could be implemented)
- Substituting top down forecasts for the bottom up forecasts used by Telstra (and conditionally accepted by the ACCC) in the draft decision. This also includes a reversal of some of the proposed WIK changes to avoid double counting
- The impact of reversing the ACCC's changes on asset lives for copper cables, which we find to be unsubstantiated.
- The impact of calculating price changes using an NPV method rather than based on nominal revenues

The final price change based on these limited adjustments is -9.7%, applied as per the ACCC's approach as a uniform price change across all declared fixed line services (FLS).

Figure 1: Summary of corrections to the ACCC draft decision



Source: Frontier, based on ACCC and Telstra FLSM

In our view, the ACCC should be wary of any finding that leads to price changes that are higher than those suggested by our calculations. It would suggest that

Telstra's cost information has not been scrutinised sufficiently, or implemented in a way that is consistent with WIK's analysis.

We also make one final point about the prospect of price reductions and the significance of 'price stability'. It is important to note that we are not arguing that prices should fall due to Telstra's NBN Co deal. There are two other material reasons why prices should fall from the 2011 FAD: (a) the lower WACC (which is driven by falls in the risk-free rate)⁴; and (b) because cost forecasts in the base year have fallen substantially (reflecting cost forecasts from the earlier FAD period that were simply too high.) Model changes relating to the NBN migration predominantly have the effect of ensuring that access seekers and end users are made no worse off by the migration. In that light, cost and price reductions should be seen as unremarkable and expected.

⁴ We calculate that without this fall, the ACCC's FLSM would have produced a uniform nominal price increase of over 11 per cent.

1 Introduction

1.1 Background

In March 2015, the ACCC issued its draft decision on the primary price terms to be included in the final access determination (FAD) for the seven declared fixed line services supplied by Telstra on its copper network.⁵

The ACCC draft decision uses a building block model (BBM) pricing methodology to determine prices for Telstra's declared fixed line services. This approach was adopted by the ACCC in the 2011 fixed line services FADs inquiry. This 2011 access determination contained 'fixed principles' provisions that lock in certain matters until a nominal termination date. Identical fixed principles were subsequently included in the 2013 wholesale ADSL FAD. The fixed principles provisions for all declared fixed line services apply until 30 June 2021.

In making its draft decision, the ACCC also engaged WIK-Consult (WIK) to report on the prudence and efficiency of Telstra's operating expenditure and capital expenditure forecasts submitted on 3 October 2014.

The release of the ACCC's draft decision and WIK report has followed a period of consultation and deliberation, which has included the following stages:

- On 11 June 2014, the Commission gave a disclosure notice to Telstra for the disclosure of information that has been provided under the Building Block Model Record Keeping and reporting Rules (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.

⁵ 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

- 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.

1.2 The draft decision and WIK consultancy

The ACCC's draft decision is for a one off 0.7 per cent decrease in the primary prices of the declared fixed line services, for the four year period commencing on 1 July 2015 and finishing on 30 June 2019.

The ACCC states that its decision is based on information received from Telstra over a long period and up to 30 January 2015.

The ACCC notes further that, since then, Telstra has submitted additional information, including revised forecasts.

Moreover, the ACCC notes it is making its draft decision without some information it needs to form a view on the prudent and efficient costs of supplying the declared fixed line services.

The ACCC states that it has dealt with this situation by making adjustments where information has been adequate to do so and by otherwise basing its draft decision on Telstra's expenditure forecasts submitted as at 30 January 2015 and assuming that Telstra will be able to satisfy the ACCC as to the prudence and efficiency of its expenditure proposals before the publication of the ACCC's final decision.

The ACCC finally states that:

If the ACCC cannot be satisfied as to the prudence and efficiency of Telstra's expenditure proposals based on the further revisions Telstra submitted on 6 February 2015 and any subsequent information provided by Telstra, it will make further adjustments to the expenditure forecasts in making the final access determinations. The ACCC is doing this in order to meet its timetable to make the FADs by 30 June 2015.⁶

WIK was engaged by the ACCC to:

⁶ ACCC draft decision, p. 12.

undertake a formal assessment of the prudence and efficiency of Telstra's forecast operating expenditure while having regard to any relevant regulatory obligations or requirements applicable to providing the declared fixed line services.⁷

WIK identifies a large number of issues with Telstra's base year expenditures and forecasting approach. Some of these result in clear recommendations about reductions in forecast expenditures and the calculation of revenue requirements in the FLSM. However, WIK also noted the following:

[27]...Some other findings which we presented (only) give reason to doubt the efficiency and prudence of Telstra's expenditure forecast. Telstra's expenditure forecast model did not allow us in these cases to translate our identification of faults and deficiencies into concrete corrections of the FLSM model. The forecast model does not provide the level of disaggregation of calculations which allows for that.⁸

[30]...A variety of other faults and deficiencies which we identified would also lead to a reduction of CAPEX and OPEX and to a reduction of expenditure allocated to the fixed line services. The combined effect of the quantitative implications of our proposed changes to the expenditure forecast and the allocation of costs to the declared fixed line services would lead to a price decrease of the declared fixed line services and not a price increase.⁹

WIK's conclusion raises fundamental questions about the overall prudence and efficiency of Telstra's forecasts:

[31.] Our findings regarding the prudence and efficiency of Telstra's forecast expenditure are less compatible with a price increase but more with a price decrease, without being able to quantify the exact amount of a necessary price decrease.¹⁰

Given these unresolved questions, we do not think that the ACCC can be satisfied as to the prudence and efficiency of Telstra's forecast expenditures.

1.3 Our instructions and the structure of the report

We have considered the ACCC's draft decision and WIK report. These reports leave a clear impression that the ACCC is in a difficult position. By the ACCC's own admission, its ability to make a draft decision has been compromised by a lack of information. Even more fundamentally, WIK has raised a raft of concerns about the adequacy of Telstra's information and its forecasting approaches. The main question is whether these concerns can be resolved satisfactorily in the time available. In our opinion, the ACCC could not make a fully informed decision that addresses all of WIK's concerns, and gives access seekers sufficient time and

⁷ Ibid., p. 12 fn 19.

⁸ WIK report, p.6.

⁹ Ibid.

¹⁰ Ibid. pp. 6-7.

opportunity to scrutinise adequately any new information supplied by Telstra since the publication of the draft decision, in time for the ACCC to make a final decision by 30 June 2015.¹¹

This leaves access seekers in a difficult position with respect to making submissions. The ACCC has offered scant detail about its current thinking on many issues (including many issues raised by WIK), other than it requires more information from Telstra. This means that, according to the ACCC's current timetable, there will be no opportunity for access seekers to comment on the ACCC's thinking as it emerges, following the submission of any new information by Telstra.

Equally, the one proposition that can be supported strongly – that access seekers should not suffer from Telstra's loss of economies of scale from the NBN rollout – implies quite strong results about the cost forecasts in any event. In particular, it implies that unit costs should be held largely fixed with respect to the NBN rollout, regardless of whether there are fixed costs which might otherwise result in an increase in unit costs and prices.

We have structured our submission in the following way:

- In Section 2, we analyse aspects of the draft decision and identify a suitable way forward that takes account of the severe information asymmetry, which the ACCC (and access seekers) face.
- In Section 3, we provide an analysis of WIK's reports and the changes to the FLSM that could be applied to be more consistent with the WIK approach. This includes a more high-level, 'top down' approach to forecasting that is, at the very least, a useful cross-check in situations where detailed information cannot be obtained. Our analysis shows that significant price reductions are required under both forecasting approaches.
- Finally, in Section 4, we comment on some other more minor aspects of the ACCC's draft decision.

¹¹ We note that the ACCC suggests on its website (April 2015) that it is unlikely to make a final decision by June 2015, but offers no further timetable details.

2 Analysis of the draft decision and implications for the final decision

2.1 The draft decision shows the significance of severe information asymmetry

In its draft decision, the ACCC raises a myriad of problems with the information put forward by Telstra, relating to both the base level of expenditures and to the trends in expenditure over subsequent years.

As examples, the ACCC notes that:¹²

The ACCC is concerned that for its base-year and forecasts of operating expenditure, Telstra has not demonstrated a transparent and verifiable cost allocation approach that permits sufficient scrutiny of:

- the traceability of costs from asset class to general ledger
- whether costs incurred in Telstra's fixed line cost centres are relevant to the provision of fixed services and
- how forecast operating expenditures respond to changes in forecast demand.

...

Telstra's allocation of its operating expenditures from its cost centres to fixed line asset classes is both complex and opaque. This may be partly explained by the complexity of its operations, but it may also be explained by the limitations of Telstra's systems. Most of the estimated fixed line cost centres appear not to be automatically generated from a single, transparent cost allocation system. Telstra's attribution of cost from the general ledger-cost centres to fixed line asset classes is based on a composite of discussions with internal staff from relevant cost centres, surveys, and different allocation systems and multiple databases.

The ACCC notes the implications of this are that¹³:

there is the possibility that the model may allocate:

- non-fixed line costs to fixed line cost centres
- more cost centre operating expenditures to asset classes that do not have a growing allocation to NBN
- operating expenditures to asset classes where rollout projects are undertaken on behalf of NBN so these costs are borne by access seekers and

¹² ACCC draft decision, pp. 27-31.

¹³ Ibid., p. 32.

- more business unit/cost centre operating expenditures to asset classes that have either a growing allocation to declared services or a slower decline in the allocation to declared services.

The ACCC notes further that this problem is not resolvable using a benchmarking analysis, given the lack of suitable comparators.

The ACCC's consultant, WIK, adds that:

Generally, Telstra has an incentive to overstate expenditure.... The firm has an incentive to inflate base year expenditures, to the extent possible, beyond the level actually incurred. Insofar as the forecasting methodology derives forecast values from base year(s) values inflated base year values also inflate the expenditure forecasts above the level of intended expenditure....because the ACCC has not pre-structured the way and methods in which Telstra has to present its expenditure forecasts, there may be a significant degree of discretion for Telstra on how to conduct and present its forecasts.¹⁴

These problems have also extended to frequent revisions of cost information. Telstra has submitted initial forecasts in June 2014, revised forecasts in October 2014, January 2014 and February 2014.

Notwithstanding these problems, the ACCC has largely accepted the forecasts used by Telstra in the absence of better information. The ACCC flags that it is seeking more information from Telstra:

The ACCC has dealt with this [lack of information] by making adjustments where information has been adequate to do so and by otherwise by basing its draft decision on Telstra's expenditure forecasts submitted as at 30 January 2015 and assuming that Telstra will be able to satisfy the ACCC as to the prudence and efficiency of its expenditure proposals.¹⁵

The ACCC's approach here seems hopeful at best. Part of the issue appears to be that Telstra's information and accounting systems do not extract the required information in a useful form (i.e. in a form that allows for checking of cost causality). However, another part of the problem seems to be that Telstra has made judgements about cost allocation that have not been made transparent to the ACCC (or to other parties):¹⁶

Since Telstra has submitted that it has identified key activities and cost drivers underpinning both base year and forecast operating expenditures, information on cost traceability from asset class to the general ledger should be available.

If Telstra has not been able to satisfy the ACCC that it has the required information, then is this likely to change before a final decision is released?

¹⁴ WIK report, Section 3.2.4.

¹⁵ ACCC draft decision, p. viii.

¹⁶ ACCC draft decision, p. 33.

We are told by Telstra that it expects to make available to the ACCC additional information:¹⁷

Telstra is also preparing a further detailed reconciliation of the base year FLSM operational expenditure amounts, to operational expenditure in Telstra's General Ledger accounts.

However, there would appear to be no opportunity within the ACCC's timetable for access seekers to scrutinise and comment on that information adequately.

A further concern is that Telstra is unable to link changes in costs to changes in asset quantities in a systematic way. This may not be a material problem in a stable environment (where the network is neither contracting nor expanding) but is a major issue where network investment and operating expenditure is expected to decline due to the NBN. Telstra's responses to the ACCC indicate that it simply does not have the relevant information:¹⁸

These questions and the associated templates seek, among other things, detailed forecast information on physical asset quantities and network topology (that is, geographic-specific forecasts on physical assets).

As explained in the Forecast Model Documentation, forecasts of capital expenditure are not developed by reference to forecast quantities of network assets expected to be required. Rather, Telstra's forecasts are developed based on historic trends in capital expenditure requirements, with adjustments for expected changes in demand for fixed-line services over the forecast period due to NBN migration.

Although physical information (i.e. quantities of specific infrastructure – measured in relevant units) is available for key asset types across the different FLSM Asset Classes, this information is generally point-in-time data. Telstra does not forecast physical quantities of assets in a systematic way.

All told, this presents a story of information asymmetry that is of significant concern to access seekers and should be of significant concern to the ACCC.

2.1.1 Telstra has already benefited from this asymmetry

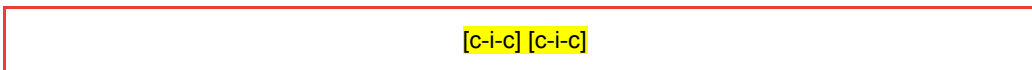
A further factor that the ACCC should take into account is the extent to which Telstra has already benefited from the fact that the ACCC has to date had inadequate information from Telstra.

It is now abundantly clear from the ACCC's draft decision and associated FLSM that Telstra's allowed operating costs for the prior regulatory period (including the 2014-15 roll over year) were far too high. This may be observed from the following figure, which shows the impact of the change in methodology to estimate 'base year' costs.

¹⁷ Letter from Telstra to the ACCC, 18 February 2015.

¹⁸ Telstra response, 30 January 2015.

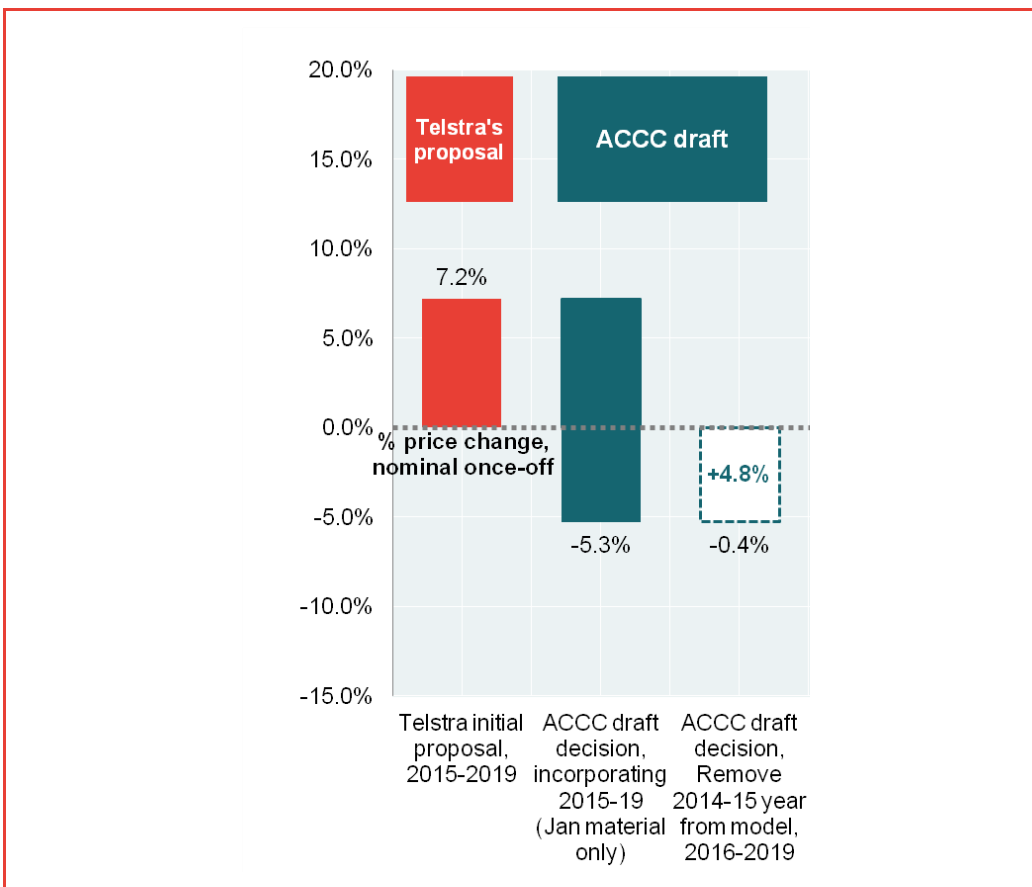
Figure 2: Changes in Opex, 2013-14 to 2015-16



Source: ACCC

The key issue here is that although 2014-15 is the new base year for the FLSM, the amount actually recovered in access charges is based on the 2013-14 costs. This leads to a large overpayment in opex costs [c-i-c] [c-i-c] which results in a material price difference. An indication of the size of the difference can be gleaned from adding the extra (prior) year to the ACCC’s FLSM (1.2). Our analysis suggests that the prices through the next regulatory period would be nearly five per cent lower if the lower level of costs in 2014-15 (and the 2014-15 over recovery) **alone** were accounted for.¹⁹ This is shown in Figure 3.

Figure 3: Impact of not incorporating 2014-15 FY in the draft decision



Source: Frontier analysis of ACCC and Telstra FLSM

The ACCC has determined in the draft decision that taking these inflated costs into account would be akin to ‘backdating’ the pricing determination and that the

¹⁹ This has a value of around \$130 million (i.e. the revenue earned less the revenue requirement).

model is forward looking.²⁰ However, this is affecting prices right now, and an alternative interpretation is that this is simply a case of obtaining better information about the efficient costs of supplying services. To not take this new information into account essentially allows Telstra to keep the gains associated with higher prices in a period after the formal price determination period has expired.

Even if the ACCC is unwilling to claw-back or prevent this current over-recovery, it should at least recognise, when assessing forward-looking prices, that Telstra has enjoyed these benefits.

This particular example illustrates the broader lesson that the current approach based primarily on seeking cost information from Telstra has already allowed many opportunities for the information asymmetry to manifest.

2.2 The information asymmetries are severe and should not be ignored in the final decision

The analysis provided by WIK, and the ACCC itself, makes clear that the information asymmetries between Telstra and all other parties, in respect of Telstra's efficient costs, are very deep. Despite the lengthy process of engagement between the ACCC and Telstra, and despite the ACCC's efforts towards gathering the information necessary to make an informed assessment of efficient costs, large information gaps remain.

Given the relatively short time remaining under the ACCC's existing timetable, it seems very unlikely that these gaps can be closed satisfactorily.

2.2.1 The ACCC should set allowances independently of the information provided by Telstra

Under the current regulatory structure – with no opportunity to reconcile actual costs with actual revenues – Telstra has a profit incentive to inflate its forecasts above the efficient level. In the presence of large information asymmetries, these incentives would be strengthened considerably as the likelihood of the ACCC detecting the inflation of forecasts above the efficient level would be low.

This means that unless the ACCC takes a very different approach to the one it followed in the draft decision, the final decision is likely to be made on very poor information about Telstra's efficient costs. For the reasons described above, this would likely result in FADs with prices in excess of the efficient level, which would be counter to the long-term interests of end-users.

²⁰ This is notwithstanding that the ACCC does take into account the forecast costs for capex and depreciation to roll the RAB forwards. See ACCC draft decision, p. 169.

When a regulator cannot obtain reliable or adequate information from a regulated business, as appears evident in this case, a reasonable regulatory approach would be to decouple cost allowances from the information submitted by the business.²¹ In the draft decision, whilst the ACCC and WIK have raised several, non-trivial concerns about the quality, reliability and adequacy of information supplied by Telstra, the ACCC has accepted, to a large extent, Telstra's forecasts. Although this acceptance is conditional we are not clear what standards the ACCC will set before it accepts the forecasts.

Under the current circumstances, the ACCC should, in our view, go much further than it has in terms of questioning and scrutinising the information supplied by Telstra. If sufficient confidence cannot be gained about the robustness of the information provided by Telstra, the ACCC should set cost allowances based on information that is independent of information provided by Telstra.

If Telstra considers that the allowances set on this basis are inappropriate, then it ought to shoulder the burden of proof to adduce sufficient evidence to support its forecasts and to satisfy the ACCC and other interested parties. The burden should not fall on the ACCC and access seekers (as is currently the case) to justify that Telstra's forecasts are unsound.

We agree broadly with the ACCC's use of a base-step-trend approach to setting cost allowances. Our review of the draft decision and analysis produced by WIK suggests that the information provided by Telstra to support its base level of expenditure, and the future rate of change in costs, is not reliable.

2.2.2 Determining the prudent and efficient level of base year expenditure

In the draft determination, the ACCC noted that Telstra had made a large downward adjustment to its base year expenditure (compared to the FAD 2012/2013 forecast). Nevertheless, the ACCC noted that Telstra's cost allocation methodology lacked transparency in cost traceability, which presents difficulties in addressing the issue of whether Telstra's base year actual operating expenditures are prudently and efficiently incurred.

²¹ Another approach taken by regulators, when faced with the information asymmetry problem, is to strengthen incentives on the business to forecast costs accurately, and to reveal those costs truthfully. Menu regulation, which is used by some regulators in the UK, is an attempt at doing this. However, if the regulated business itself has poor information on its future costs (e.g. due to poor historical record keeping), strengthening incentives to improve the accuracy and truthful revelation of forecasts may be ineffective. This appears to be the case in this instance. In such circumstances, it may be appropriate to set allowances in a way that does not rely heavily on information provided by the regulated business.

Given the opacity of Telstra's cost allocation methodology, the ACCC could not, in our opinion, reasonably form a view on the prudence and efficiency of Telstra's base year expenditure level. The ACCC decided in its draft decision not to adjust Telstra's base year expenditure, but to conditionally accept it.

In our view, it would be inappropriate for the ACCC to accept Telstra's base year expenditure proposal because Telstra has provided the ACCC with insufficient information to assess the prudence and efficiency of those costs. This 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. This opens opportunities for gaming, particularly when businesses have a significant information advantage over the ACCC and other parties.

Another reason such a decision would be inappropriate is because, under a base-step-trend approach, the effect of over-recovery, through inflated base level allowances, would flow through as inefficiently high access prices in subsequent years. This point is noted by WIK in its advice to the ACCC²²:

109. Telstra's expenditure forecast methodology significantly relies on the base year expenditure. Any double-recovery of expenditure in the base year due to blurred definitions of expenditure categories then impacts the expenditure forecast for the regulatory period and extends the problem over the upcoming regulatory period.

And

122. The firm has an incentive to inflate base year expenditures, to the extent possible, beyond the level actually incurred. Insofar as the forecasting methodology derives forecast values from base year(s) values inflated base year values also inflate the expenditure forecasts above the level of intended expenditure.

Unless the ACCC can satisfy itself that Telstra's base level expenditure is prudent and efficient, it risks entrenching inefficiently high access prices permanently.

For this reason, when assessing the prudence and efficiency of Telstra's forecasts, it is highly desirable that the ACCC develop its own, independent estimate of base year expenditure. In this regard, it is instructive to consider the approach that the Australian Energy Regulator (AER) follows when assessing forecast expenditures. Like the ACCC in this matter, the AER follows a base-step-trend approach to determining cost allowances for Network Service Providers (NSPs).

Broadly, the approach taken by the AER is to develop its own, independent estimate of an NSP's costs and compare these to the forecasts submitted by the NSP. If the NSP's cost forecast exceeds that of the AER's, and there is no satisfactory explanation for this difference, the AER takes the view that the NSP's forecasts are not prudent and efficient. The AER will then substitute its own forecasts for the NSP's. In the latest draft decisions for NSW and ACT

²² WIK report, paragraph reference as noted.

electricity distribution networks, the AER developed alternative estimates of base year opex for each of the networks. In all instances, the AER's estimate of base year costs was lower than the estimates put forward by the NSPs. The AER concluded that the NSPs' base year opex did not meet the expenditure criteria set out in the National Electricity Rules, which deal with, amongst other things, the prudence and efficiency of expenditures. The AER therefore proposed to substitute the NSPs' base year opex estimates with its own.

We think that the general principles underpinning the AER's approach to assessing the prudence and efficiency of expenditure forecasts (and base year costs in particular) are correct and should be adopted by the ACCC in this instance. The question is, how should the ACCC develop an alternative and independent estimate of base year expenditure?

One option would be for the ACCC to commission a detailed engineering and economic assessment of Telstra's network to form its own view on the prudent and efficient level of costs in the base year. This would necessitate the ACCC's experts gaining a good understanding of Telstra's network in order to develop a bottom-up estimate of costs. However, it seems that the ACCC has already sought information from Telstra about its network (e.g. on asset volumes in different classes) and Telstra has been unable to provide that information. So, a detailed engineering assessment would be time consuming, costly and likely to be frustrated by lack of information about Telstra's network.

A more feasible and pragmatic alternative would be for the ACCC to undertake a less involved costing exercise that does not rely exclusively on information on Telstra's network. The starting point would be to understand, at a high level, the most important characteristics or features of the network delivering the regulated services. This may involve some judgment and assumptions. However, in the absence of helpful evidence from Telstra, the exercise of such regulatory judgment would be more justified than accepting, without challenge or hard scrutiny, the prudence and efficiency of base year expenditures proposed by Telstra.

Having enumerated the key characteristics of the network, the next step would be to estimate the costs associated with operating a network with those features. Again, this would necessarily be a rough exercise, involving judgment and assumptions. However, in our view, it is better to follow such an approach than to accept untested (and untestable) estimates from Telstra.

One way to derive these estimates would be to examine the costs associated with similar networks (either in Australia or in other jurisdictions), having accounted properly for differences in operating environments. If Telstra considers that there are shortcomings with the ACCC's estimates of base year expenditures by this method, it should fall on Telstra to improve those estimates by supplying reliable and robust evidence – not least because it enjoys an information

advantage over the ACCC and stakeholders. If Telstra is unable to do that, the ACCC should substitute its estimate of base year expenditure for Telstra's.

We acknowledge that such an exercise is unlikely to be possible within the ACCC's timetable for determining the FADs. However, the ACCC needs to trade-off the costs associated with extending its self-imposed timetable, in order to undertake a more robust assessment of Telstra's costs, against the risk of determining access prices that are imprudent and inefficient, the costs of which would be borne permanently by consumers. In our view, 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 it followed in the draft determination.

2.2.3 Determining the rate of change in costs

In respect of the rate of change in costs, WIK has made a number of specific recommendations for improvements on Telstra's proposal. Several of these recommendations can be implemented, even with the limited information available. In addition, we have identified a number of separate improvements that we consider should be applied by the ACCC. In Section 3, we describe and apply these recommendations, and demonstrate that their implementation would be both simpler and lead to a significant reduction in the access prices.

2.3 The ACCC should not allow charges to rise due to loss of (NBN related) economies of scale

The ACCC's draft decision notes that one of the issues on which it is still undecided is how to deal with the consequences of the NBN migration:

A further impact of the NBN is the increase in unit operating costs that will occur 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 considers that the loss of economies of scale and density is incremental to the NBN and is still considering its approach on this issue.²³

It seems plausible that the NBN migration will cause a loss of economies of scale. Nonetheless, we are strongly in agreement that:

- The NBN migration is a voluntary action by Telstra, backed by large scale payments for migration of customers by NBN Co

²³ ACCC Draft Decision

- Access seekers are not responsible for the migration and derive no direct benefits from the NBN Co agreements, and so should not be forced to bear its consequences.

This follows from our October 2014 submission, in which we said:²⁴

Allowing Telstra to recover NBN-related capex and higher unit costs from access seekers – and ultimately end users – means there would be a significant prospect that Telstra would recover the costs of supplying services more than once.

In our view, the ACCC should make two adjustments to Telstra's forecasts to ensure that they will lead to prices for the declared fixed line services which promote the LTIE:

- Remove all capex that is incremental to NBN Co's demand for fixed line assets.
- Ensure that the forecasts of costs are consistent with the NBN migration causing no loss of economies of scale (no increase in unit costs due to the NBN).

This also appears to be entirely in agreement with the ACCC's consultant, WIK, which stated:²⁵

The concept of basing FLS-tariffs on costs implies that only those costs should be included in the cost base which are incremental to the provision [of] FLS. That principle is fundamental. Any additional expenditure incurred by Telstra due to the NBN roll-out is not caused by the business of access seekers. The same applies on the increase of average costs by FLS.

In fact, we consider this principle should not be particularly controversial. The only issues that remain to be resolved relate to how, specifically, the loss of economies of scale should be measured and accounted for in the costs forecasts. We turn to this issue in the following section.

2.4 The FLSM transparency should be improved

Overcoming information asymmetry requires a serious commitment to openness of information and clear documentation. In this regard, we note that the information asymmetry has not been diminished by:

- (a) the multiplicity of models produced by Telstra
- (b) the fact that the ACCC's version of the FLSM contains more 'hard coding' and is actually much less transparent than Telstra's.

In the course of our review of the ACCC's decision, we have attempted to understand the differences between the Telstra and ACCC versions of the FLSM.

²⁴ Frontier October 2014 submission, available at www.accc.gov.au

²⁵ WIK-Consult, *Assessment on the efficiency and prudency of Telstra's expenditure forecasts*, March 2015, p. 95. (WIK report)

However, this approach has proved difficult in important respects. One example is cost allocations: if the ACCC has now decided to use Telstra's fully allocated costing approach, we do not understand why it decided not to tie cost allocations to demand forecasts directly and capture all of these interactions within the model.

The primary issue with this approach is that it reduces our ability to trace the ACCC's decisions that are made outside of the model (which are not described in its written reasons). A secondary issue is that it introduces scope for errors that cannot be identified, even with careful auditing.

We outline further the difficulties we have encountered in reconciling the two models in Box 1.

Box 1: Reconciling the Telstra and ACCC FLSMs

[c-i-c] [c-i-c]

Source: Frontier

To facilitate proper analysis by interested parties, the ACCC should release a more fulsome explanation of how it has used Telstra's version of the model to derive its own results using its model, or otherwise trace how the numbers produced by Telstra feed into the ACCC FLSM.

3 Taking adequate account of WIK's analysis

WIK has produced an extensive critique of the forecasts produced by Telstra, both with respect to the base year costs, and the forecasting forward of those costs.

Notwithstanding this critique, the ACCC has not taken some of the issues raised by WIK into account or explored their implications in the draft decision. We understand that this may have been driven by the ACCC's desire to issue a draft decision to meet its proposed timetable for issuing the final FAD. Nonetheless, our own analysis suggests that the appropriate application of WIK's recommendations would lead to a material price reduction in the declared service prices. Hence, the ACCC should have proper regard to these recommendations when it makes its final decision.

In this section, we set out our interpretation and implementation of (some of) WIK's proposed changes, which provides the baseline for further consideration of any new data supplied by Telstra on costs.

3.1 The ACCC needs to take further account of WIK's analysis

WIK was engaged by the ACCC to assess whether expenditures forecast by Telstra for its FLS are prudent and efficient.

WIK raises significant concerns about the transparency of Telstra's forecasts, the derivation of the forecasts, and the approach to dealing with NBN migration.

On the whole, the WIK report is highly critical of Telstra's proposed approach to determining base year costs, and forecasting beyond the base year:

- On the determination of **base year** costs, WIK observes that Telstra has not related these costs to relevant quantities of activities (e.g. [c-i-c] [c-i-c]) or assets (e.g. equipment counts) in a systematic and hierarchical way
- On **forecasts**, WIK notes a lack of information of underlying cost drivers, inconsistencies and inappropriate forecasting methods (particularly in respect of capex).

Further, WIK also raises material concerns about the consistency of Telstra's methods for allocating costs with the NBN migration: Telstra's approach has both allocated too much cost to fixed line services, and also imposes on access seekers costs related to the loss of economies of scale caused by the migration.

WIK concludes that its recommended changes could not be implemented immediately in full, but if this were done it would result in a price decrease rather than a price increase.

A variety of other faults and deficiencies which we identified would also lead to a reduction of CAPEX and OPEX and to a reduction of expenditure allocated to the fixed line services. The combined effect of the quantitative implications of our proposed changes to the expenditure forecast and the allocation of costs to the declared fixed line services would lead to a price decrease of the declared fixed line services and not a price increase.²⁶

We support many of WIK's proposed changes and consider that the ACCC's final decision will be fundamentally compromised if it does not deal effectively with all the issues discussed below.

3.1.1 Fixing base year costs

As noted in Section 2.2, we agree broadly with the ACCC's use of a base-step-trend approach to setting cost allowances. Our review of the draft decision and analysis produced by WIK suggests that the information provided by Telstra to support its base level of expenditure, and the future rate of change in costs, is not reliable.

A key issue raised by WIK is in Section 6. WIK notes that:

- Telstra's Forecast Model does not allocate expenditure to services, but allocates expenditure to asset categories (classes)
- the Forecast Model does not distinguish between expenditure that is related to regulated FLS, non-regulated FLS, NBN and other services
- while the FLSM then allocates this expenditure to services, the fact that expenditure is not related to services directly means that it is not certain that the FLSM allocates expenditure to services according to cost causation.

WIK proposes that the Forecast model (and FLSM) should allocate expenditure according to subcategories of the asset classes, reflecting:

- Attribution to regulated FLS
- Attribution to non-regulated FLS
- Attribution to NBN services
- Attribution to other services

The benefit of WIK's proposed approach is that it would reduce the extent of problems such as that created by NBN expenditure. In that case, it is clear that there is expenditure on asset classes which would be used by both the NBN and FLS. However, the expenditure is clearly being driven by NBN Co's demand for services/assets, and that without NBN Co's demand, much or all of that expenditure would not be required. In this case it seems legitimate for FLS to

²⁶ *ibid*, p. 6.

contribute to recovery of the RAB for those assets, but not for new expenditures which offer no benefit to FLS users.

Fundamentally, this appears to reflect a weakness in the FLSM that it is treating too much cost as shared cost, to be recovered using usage-based allocation keys.

This is unlikely to be a significant problem if the services are in a reasonably steady state, where usage correlates with required expenditure to produce the services. However, in an environment of transition, where some services are declining materially, usage-based allocations seem ill-suited to deal with expenditures that are being driven fundamentally by (a) specific FLS and/or (b) NBN-related services.

Telstra's current approach also appears to allow it considerable discretion to allocate more costs to asset classes that involve less sharing with non-regulated services (and so result in relatively higher FLS prices).

In our view, WIK's approach has merit even though it appears difficult to analyse and classify expenditure in the way proposed in the near term.

For this reason, we understand, WIK recommends a price freeze until these issues can be resolved.²⁷ However, for the reasons we point out in this section, this is not appropriate as (a) a price fall is clearly justified and (b) it would reward Telstra for not providing sufficient information to justify the prudence and efficiency of its forecasts.

In the short term, the ACCC should continue to determine, with greater rigour, estimates of base year costs (including further analysis of how costs are allocated from Telstra's general ledger to specific asset classes). At the same time, it should move towards improved information capture and independent cost estimation in the medium term.

3.1.2 Cost forecasts

WIK observes a lack of information of underlying cost drivers, inconsistencies and inappropriate forecasting methods (particularly for capex).

In our view, a major concern raised by WIK is the lack of suitable cost drivers for opex and capex.

- With respect to opex, the cost drivers should ultimately relate to some activity and quantities of maintenance (which would relate to total assets deployed).
- With respect to capex, the cost drivers should ultimately relate to asset quantities and how these change with demand.

²⁷ *ibid*, p. 7.

This manifests in no clear relationships between assets, costs and volumes of services (AVR and CVR). In most instances costs are hardcoded in the base year and forecasts derived from this base.

WIK's recommendations (outlined in section 5.8.3. of its report) are to derive a much more rigorous set of relationships between cost centres. This would allow for clearer classification of which costs are directly attributable to which asset classes, rather than the higher aggregated and opaque approach that is currently adopted.

Again, we support the approach taken by WIK but note that it would be considerable work to analyse and classify costs in the manner prescribed. This is not a good reason to not implement WIK's recommendation; as we have argued this is important to address the information asymmetry between Telstra and other parties. However, we also consider this provides further support for taking a higher-level top down approach to cost forecasting.

3.2 Even limited adjustments show that significant price falls are mandatory

In the draft decision, the ACCC made two changes on WIK's recommendation – it removed the NBN-related capex and propex, and has adjusted its treatment of copper cables as asset disposals.²⁸

In part, this minimal adjustment occurs because only some of WIK's proposed changes could be made without reference to further information from Telstra. It appears that information was sought from Telstra to assist with making WIK's proposed adjustments, but Telstra has reported that it does not collect information of the form necessary to implement such changes.

Further changes proposed by WIK include:

- [c-i-c] [c-i-c]

We have examined these proposed changes and considered how they could be reasonably implemented without recourse to further information from Telstra.

3.2.1 Treatment of duct and pipe costs

- [c-i-c] [c-i-c]

²⁸ It is not clear whether the ACCC specifically made this change on WIK's recommendation, but WIK did note that Telstra had not correctly treated all customer migrations as leading to disposals of copper cables, rather than only cables which are required for NBN rollout (FTTN areas). See p. 6.

3.2.2 Treatment of exchange capacity

- [c-i-c] [c-i-c]

3.2.3 Reallocation of propex

- [c-i-c] [c-i-c]

3.2.4 [c-i-c] [c-i-c]

- [c-i-c] [c-i-c]

3.2.5 Capex transparency and forecasting

- [c-i-c] [c-i-c]

3.2.6 Treatment of transmission capacity costs

- [c-i-c] [c-i-c]

3.3 A top-down forecasting approach for opex and capex also supports material price reductions

As we have argued, Telstra has strong incentives to overstate costs and if the ACCC and/or Telstra want to rely on more detailed and refined forecasts, then it is incumbent on Telstra to produce the information that would allow proper scrutiny of the costs and relationships embedded in such forecasts. The ACCC has said that it assumes that Telstra will be able to satisfy that its costs are efficient and prudent. In our view, there is considerable doubt about whether this can be achieved in the time available.

If the ACCC is minded to make a decision in the short term (on or around June 2015), we suggest that:

- The ACCC should seek further information from Telstra on the *base year* costs for opex and capex, and satisfy itself as best it can that costs have been appropriately allocated to RAB asset categories (and not double counted)
- Once the base year costs have been established, the ACCC should forecast the *aggregate* opex and capex forward in proportion to the changes in SIOs due to the NBN rollout.

This approach to forecasting would have a number of benefits compared to the existing methods proposed by Telstra.

- A ‘top-down’ approach to forecasting that would obviate the need to make a detailed, bottom-up assessment of changes in Telstra’s costs, which is proving to be very information-intensive and deficient in key respects.

- Aligning the opex forecasts with the migration of SIOs will reflect that the primary driver of cost changes will be the NBN rollout and will also ensure that access seekers are no worse off from the rollout, in line with WIK's recommendations. Allowing Telstra to pass on the costs of diseconomies of scale cannot be justified by economics or by the requirement to protect Telstra's legitimate commercial interests.
- Aligning the capex forecasts with the migration of SIOs will reflect that the copper network is in a declining phase, with Telstra facing incentives to minimise investments (particularly in areas where copper will not be re-used).
[c-i-c] [c-i-c]²⁹

The top-down forecasting approach we are recommending would also be more consistent with the ACCC's approach adopted in 2011. At the least, it will provide a high level cross-check on more detailed – but ultimately poorly verified – forecasts if the ACCC continues to pursue the existing lines of inquiry.

3.3.1 Top down forecasts for opex and capex

We have determined forecasts for opex and capex using the following principles:

- We use 2014/15 as the base year from which to begin the forecasts. Prior to 2014/15 a different modelling methodology was used and figures obtained are very different to those predicted by the current forecasting methodology. (Note we do not agree these costs are necessarily efficient.)³⁰
- We align the aggregate forecasts for CAN and Core asset classes with the SIO decline relating specifically to the NBN rollout. That is, we reflect the demand decline from the NBN and not the more general decline which is being experienced due to other forms of substitution.
- These aggregate forecasted amounts are then split among asset classes based on the FY15 historical proportions of opex and capex according to Telstra's data. While other methods are available (such as proportional to existing RAB values) we assume that base year splits are a more accurate representation.

[c-i-c] [c-i-c]

²⁹ Draft decision, p. 77.

³⁰ [3<]

3.4 The calculation of price changes should be amended

Both the ACCC's and Telstra's versions of the FLSM calculate a uniform price change across all services. We have not been asked to comment on that approach in principle.

However, an aspect of the calculation appears incorrect. Both models derive a price change to meet a nominal revenue requirement over the modelling period. Each dollar is valued the same, whether it is earned in the first year or the last year of the regulatory period. However, Telstra strictly prefers dollars in earlier years, due to the time value of money.

Our view is that the correct approach to determining a uniform price change is to take the NPV of the nominal dollars forecast using a nominal WACC (or real dollars using a real WACC), and to set the nominal price change that is consistent with the NPV of costs (revenue requirement) being equal to the NPV of revenues (prices times forecast quantities).

[c-i-c] [c-i-c]

Correcting this calculation reduces access prices further (all else remaining equal), reflecting that relatively more revenues are recovered in earlier periods of the price control.

Table 1 Using an NPV calculation rather than converting to nominal revenues for recovery

	Uniform price change
ACCC model price change	-0.67%
NPV price change calculation	-1.32%
<i>Difference</i>	-0.65%

Source: Frontier based on ACCC FLSM

3.5 Shortening of assumed asset lives cannot be justified

In its Building Block Model Record Keeping Rule (BBM RKR) response, Telstra assumed asset lives for forecast new investments that are shorter than the asset lives reflected currently in the Fixed Line Service Model (FLSM). The impact of assuming shorter asset lives is to accelerate the recovery of those investments (relative to the speed of recovery in the existing FLSM). It appears that the asset lives assumed by Telstra align with service lives in its accounting system, rather than regulatory assumptions.

In the draft decision, the ACCC considered that Telstra had not provided sufficiently detailed and transparent material to justify its assumption of shorter asset lives. (This would appear to be another example of the many asymmetries of information between Telstra and other parties, including the ACCC.) Therefore, with the exception of copper cables, the ACCC retained, in the draft decision, the asset lives used for the 2011 and 2013 FADs.

In our view, this is appropriate. Even if Telstra were able to demonstrate convincingly a clearer mapping of the shorter asset lives it has proposed to those used in its accounting system, this would still not be sufficient justification to alter the assumed asset lives for regulatory purposes. There is no *per se* reason why asset lives assumed for setting regulated prices should necessarily be matched to asset lives assumed by a regulated monopoly for its own commercial purposes.

Telstra has argued that it would be appropriate to shorten the assumed lives of those assets impacted by the NBN rollout — in particular, copper cables. In the draft decision, the ACCC accepted this view. The ACCC noted that while the NBN is being rolled out, Telstra would need to continue investing in copper cables. Shortening asset lives to align with the expected completion date of the NBN rollout would provide Telstra with the opportunity to recover the cost of those investments before the assets cease to generate revenue. Therefore, the ACCC has claimed that the shortening of assumed asset lives is appropriate because it maintains Telstra's incentives for efficient investment in copper cables.

This seems to us to be a *non sequitur*. Specifically, it is unclear to us that allowing faster recovery of investments in copper cables improves (or other affects) incentives for Telstra to invest in those assets. The ACCC appears to be concerned that if Telstra is unable to recover, through access prices, the cost of future investments in copper cables before the completion of the NBN rollout, those assets would become stranded. The ACCC's willingness to shorten assumed asset lives appears to be an attempt to mitigate this 'stranding' risk.

We find the ACCC's argument puzzling, for two reasons.

- The first is that it is by no means obvious that copper cables will be stranded under NBN Co's Multi-Technology Model (MTM). Although distribution cables will be replaced, many cables between network nodes and the premises will be migrated (sold) to NBN Co. The asset class 'copper cables' makes no distinction between cables that will be stranded and those that will not.
- The second reason is that the ACCC elsewhere recognises Telstra has entered into commercial agreements with NBN Co that deal with the re-use or stranding of copper cables. The terms of those agreements ought to, in part, compensate Telstra for the residual value of the copper network at the time the NBN rollout is completed. A rational and properly-negotiated agreement would have taken account of future investments in the network that would

need to be made between the signing of those agreements and the eventual migration or stranding of the cables. Hence, if Telstra had negotiated an appropriate, commercial agreement with NBN Co it would not, in fact, face any stranding risk in respect of copper network assets.

Furthermore, it should have been a feature of those agreements for Telstra to maintain an adequate service level on its copper network until such time as the NBN rollout is completed.

If Telstra has negotiated an agreement that achieves these outcomes, then allowing accelerated recovery of future investment in copper cables would amount to ‘double-dipping’, i.e. compensation for those investments twice (once through access prices, and again through payments made by NBN Co). If Telstra failed to negotiate such an agreement, it should not fall on access seekers and end-users to make Telstra whole.

For these reasons, in our view, the ACCC should not shorten the assumed asset lives of copper cables when determining the FADs.

3.6 Current information supports a material price reduction

Our analysis of WIK’s report and the ACCC’s and Telstra’s FLSM models shows that:

- Making a limited number of changes as proposed by WIK will lead to a (significant) reduction in prices, but that further changes would likely lead to larger reductions in prices that cannot be quantified (see Box 2 for a brief discussion of the nature of these further changes).
- Applying a top down forecast that uses Telstra’s existing base year forecasts and is consistent with WIKs overall approach to NBN related impacts (i.e. that Telstra should bear the costs of this) will lead an (even larger) reduction in prices.

The ACCC should therefore be wary of any finding that leads to minor price reductions. Taking into account the information produced to date, and the relevance of information asymmetry and incentives to overstate costs, a minor price reduction would suggest that Telstra’s cost information has not been sufficiently scrutinised, or changes implemented consistent with the advice of WIK.

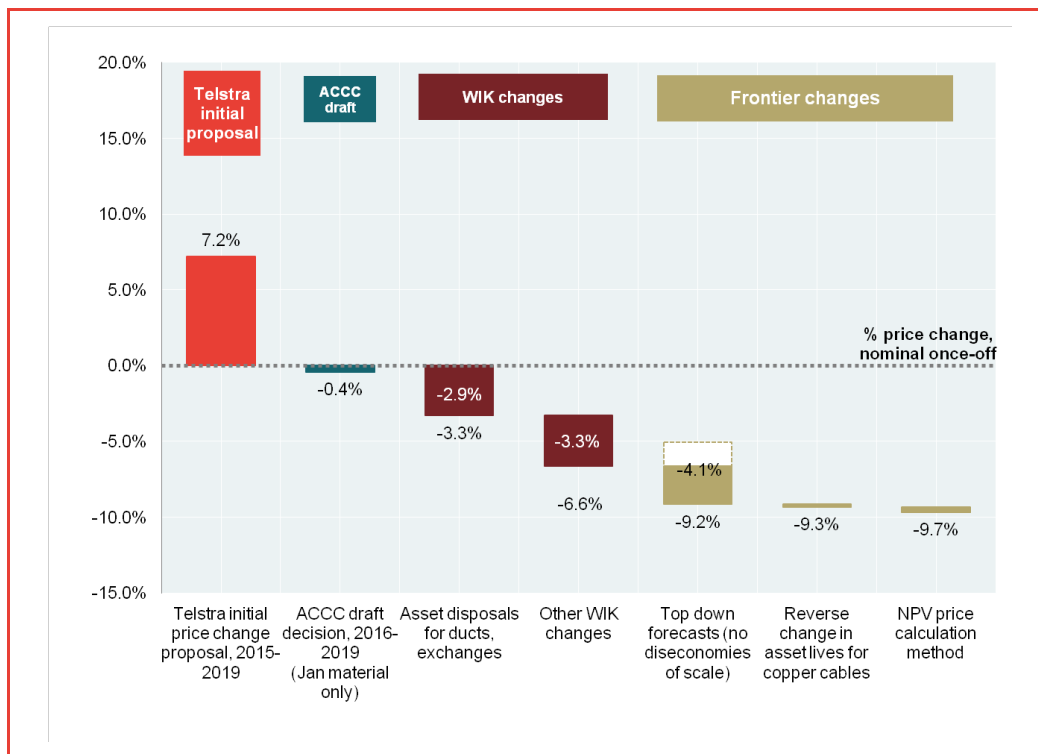
The following figure highlights the changes to prices that we consider should be made, at least on the basis of the material put before the ACCC at the draft decision. It highlights:

- Telstra’s original proposal of a 7.2% increase (later modified).

- The ACCC's draft decision, which *inter alia* involves significant decreases as a result of removing NBN-related capex and propex, a lower WACC, and other more minor changes. We show -0.4% as the result in the Figure as we cannot fully reconcile the ACCC and Telstra models, as described in Box 1.
- Incorporating overcapacity of ducts, copper cables and pipes and exchanges as asset disposals
- Making other changes as proposed by WIK (a subset of its recommendations that could be implemented)
- Substituting top down forecasts for the bottom up forecasts used by Telstra (and conditionally accepted by the ACCC) in the draft decision. This also includes a reversal of some of the proposed WIK changes to avoid double counting
- The impact of reversing the ACCC's changes on asset lives for copper cables, which we find to be unsubstantiated.
- The impact of calculating price changes using an NPV method rather than based on nominal revenues

The final price change based on these limited adjustments is -9.7%, applied as per the ACCC's approach as a uniform price change across all declared fixed line services.

Figure 4: Summary of supported price reduction



Source: Frontier, based on ACCC and Telstra FLSM

We also make one final point about the prospect of price reductions and the significance of ‘price stability’. It is important to note that we are not arguing that prices should fall due to Telstra’s NBN Co deal. There are two other material reasons why prices should fall from the 2011 FAD: (a) the lower WACC (which is driven by falls in the risk-free rate)³¹; and (b) because cost forecasts in the base year have fallen substantially (reflecting cost forecasts from the earlier FAD period that were simply too high.) Model changes relating to the NBN migration predominantly have the effect of ensuring that access seekers and end users are made no worse off by the migration. In that light, cost and price reductions should be seen as unremarkable and expected.

Box 2: Material issues raised by WIK changes

In this report, we have highlighted a number of areas where we consider changes to the cost forecasts and RAB that can be made which are consistent with WIK recommendations using existing data sources.

WIK also raises concerns about a number of other areas where we have not readily been able to make adjustments, given data limitations, but note that these would almost certainly lower costs and prices:

- **Asset disposals:** WIK notes that while Telstra disposes of copper cables, where cables are buried and not ducted the capitalised trenching costs should also count as an asset disposal. While we have incorporated some asset disposals relating to ducts, this does not specifically account for this kind of disposal.
- **Asset disposals:** There may be assets associated with copper cables which are used exclusively by NBN Co in FTTN areas
- **Cost allocations:** In our top down forecasts, we effectively hold capex and opex per SIO fixed for NBN migration. However, WIK’s analysis in paragraphs 302-320 implies that corrections for diseconomies of scale should apply to all costs – i.e. capex, opex and capital employed (which produces return on capital and depreciation expenses).
- **IMC codes and capex:** WIK raises a number of issues with the relevance of costs in certain IMC codes, such as [c-i-c] [c-i-c]. These issues mostly relate to either unclear relevance to FLS or to possible double counting with other assets.

While we cannot readily quantify these adjustments, as an example we note that even with our proposed top down forecasting based on NBN SIO migration, this does not completely eliminate diseconomies of scale in that costs per SIO in total are still rising (see Figure following). This cannot totally be accounted for by higher per SIO costs due to demand declines.

[c-i-c] [c-i-c]

The majority of the remaining WIK concerns relate to process and justification for existing forecasts or costs, and so it is unclear what kind of impact these changes are likely to have on relevant costs and prices.

Source: Frontier

³¹ We calculate that without this fall, the ACCC’s FLSM would have produced a uniform nominal price increase of over 11 per cent.

4 Other comments

4.1 CPI inflation should not be used to deflate costs to 2009 values

In the draft decision, the ACCC has indicated that it is intending to align the indexes that it uses to convert inputs and outputs into real and nominal values. This will be the Consumer Price Index (CPI). This represents a change from past FADs, where the ACCC has used a (input) producer price index (PPI) to deflate costs and the CPI to inflate output prices.

In response to the July 2014 discussion paper, Frontier noted there would be some benefit in using CPI for all conversions, the most important of which is simplicity. However, we noted that we would like to consider the proposal further. We have now had an opportunity to do so, and our considered view is that the ACCC should not use CPI to deflate the input costs.

The principal reason we disagree with the use of the CPI in order to deflate Telstra's costs is because it is an index that is designed to measure the changing cost of *consumption* by *households*. It is not designed to capture changes in *input costs* incurred by *businesses*. This is clear if one considers material published by the Australian Bureau of Statistics on the constituents, definition and purpose of the CPI.

On the constituents of the CPI, the ABS states that:³²

The Consumer Price Index (CPI) measures quarterly changes in the price of a 'basket' of goods and services which account for a high proportion of expenditure by the CPI population group (i.e. metropolitan households). This 'basket' covers a wide range of goods and services, arranged in the following eleven groups:

- Food and non-alcoholic beverages
- Alcohol and tobacco
- Clothing and footwear
- Housing
- Furnishings, household equipment and services
- Health
- Transport
- Communication

³² ABS, Consumer Price Index, 6401.0, March Quarter 2015, Explanatory Notes.

- Recreation and culture
- Education
- Insurance and financial services.

Clearly, none of these consumption goods and services are relevant as inputs to production used by Telstra to deliver the FLS.

On the definition and purpose of the CPI, the ABS states:³³

2.1 As the name suggests, a consumer price index measures the change in the prices paid by **households for goods and services to consume. All expenditures by businesses, and expenditures by households for investment purposes, are out of scope of a consumer price index.** In this regard, expenditure on housing presents particular difficulties as it can be considered as part investment and part purchase of shelter-related services.

...

2.12 Another possible purpose of the CPI is to measure **price inflation facing households as consumers.** This measure is primarily for use in macroeconomic management, and also has some possible uses in contracts where an index of prices for household consumption items is appropriate. Of course, as **the CPI measures only households' price experience,** it is not a measure of economy-wide inflation.

2.13 As there is no generally agreed definition of inflation, the issue of how it should be measured is complicated. Nevertheless, it seems clear that an index of household inflation should attempt to measure the contemporary rate of change in prices of **consumer goods and services.** [Emphasis added]

It is clear from this material that the CPI is intended to capture inflation associated with goods and services consumed by households; expenditures by businesses (e.g. on inputs to production) are not within the scope of the CPI. There is no reason to suppose that the CPI reflects inflation in the expenditure of businesses such as Telstra.

The ACCC cites four reasons why it considers CPI is appropriate for deflating costs within the FLSM. We explain below why we think none of these reasons bears scrutiny, and therefore cannot be used to justify the use of the CPI:

- *It would remove any potential bias that might arise from using different measures of inflation to convert inputs to real terms and outputs to nominal terms.* It is unclear what bias the ACCC is referring to here. The ACCC has previously stated that the purpose of deflating expenditures is to “measure price movements for inputs associated with providing the declared fixed line services”³⁴. If CPI poorly measures the inflation associated with inputs to production used by Telstra to

³³ ABS, Consumer Price Index: Concepts, Sources and Methods, 6461.0, 2011.

³⁴ ACCC, *Public inquiry to make final access determinations for the declared fixed line services Discussion paper*, April 2011, p. 113.

deliver the FLS, use of the CPI introduces bias in the measurement of costs; it does not remove bias. On average, CPI inflation has been lower than inflation measured by, for instance, the ABS's PPI for communications equipment (which the ACCC used in the 2011 FADs). Therefore, use of the CPI will tend to bias upwards access prices (relative to the prices that would result if input costs were deflated using a PPI).

- *CPI is a more stable and predictable measure of inflation than specific equipment and labour indices, which can be volatile.* This may be true as a matter of fact. However, it is also true that CPI is less relevant as a measure of inflation. It is unclear to us why a wrong measure of inflation should be preferred simply because it is relatively stable.
- *It would be consistent with the common practice among economic regulators of using the same index for all real-nominal conversions in determining regulated charges, and using CPI as the measure of inflation.* The ACCC seems to give considerable weight to the need for consistency when deflating and inflating. It is important to recognise that the values being deflated represent inputs to production. Therefore, it is entirely proper to deflate these values using an index that reflects inflation in inputs to production. The values to be inflated are real access prices, which are ultimately passed through to consumers. Therefore, those prices should arguably be inflated using the CPI (since consumer communication products and services are constituents of the CPI) as the objective should be to reflect how the nominal cost of consumption associated with FLS to consumers will evolve over time. Striving for consistency when deflating and inflating these separate values is not a meaningful exercise.
- *It is transparent and straightforward to administer.* It is unclear to us why applying a PPI deflator to input costs is any less transparent or straightforward than applying a CPI deflator. The PPI used by the ACCC in the 2011 FAD is defined clearly, published freely by the ABS, and is described by the ABS in as much detail as the CPI. Implementation of the PPI in place of the CPI within the FLSM should be a straightforward exercise, particularly since the ACCC has used it in the past for precisely that purpose.

The result of the using the CPI to deflate Telstra's costs is an increase in access prices. This increase occurs without any corresponding increase in the efficient costs incurred by Telstra – and so also appears inconsistent with the ACCC's view that prices should only change when costs change.³⁵ This would represent a windfall gain to Telstra, arising purely from a change in regulatory approach that is not supported by any sound economic rationale. It is hard to understand how it could be supported in that light.

³⁵ See footnote 38.

4.2 IIC and TEBA prices should be calculated and applied using the FLSM

The ACCC's draft decision sets a charge for the IIC that does not use the revised versions of the FLSM. Rather, the charge is that derived in the same way as that determined in the 2012 arbitral final determinations; based on a specific IIC cost model.

- [c-i-c] [c-i-c]

The ACCC notes that:

...even though the IIC is not part of the ULLS or LSS, access seekers are unable to provide ULLS or LSS based services to end users without the IIC service. Therefore, when determining prices for ULLS and LSS, IIC prices must also be determined.³⁶

This reasoning is exactly analogous to TEBA services. Access seekers cannot provide ULLS or LSS services without the TEBA service. The ACCC must also therefore determine TEBA prices.

- [c-i-c] [c-i-c]

4.3 Lack of justification for regulatory values approach

The justification for the ACCC's decision regarding its regulatory values approach is inadequate. Our previous submission pointed to a range of evidence to suggest that the 'regulatory values' approach was not a standard regulatory practice, and nor would it be consistent with economic efficiency or the LTIE.

In the draft decision, the ACCC asserts that:³⁷

- The ACCC is adopting common regulatory practice in using regulatory values as a basis for valuing transactions affecting regulated assets.
- Using the payments rather than the regulatory values would result in prices of declared fixed line services changing for reasons other than changes in the cost of supplying those services.
- The regulatory values approach will result in prices that are based on the efficient resource cost of providing services and therefore that are allocatively efficient. This will encourage efficient use of and investment in infrastructure and promote efficient competition by access seekers.

³⁶ ACCC, draft decision, p. 174.

³⁷ ACCC draft decision, Section 9.5.1, pp. 136-137.

These assertions are not supported by evidence or detailed analysis.

Aside from not citing any regulatory authorities in support of its approach, the reasoning with respect to costs is difficult to follow. In our view, it is straightforward to show that prices using regulatory values are likely to be less allocatively efficient than taking into account the value of the payments as an asset disposal. This can be shown with a simple example. Suppose the firm's initial RAB is \$100 and that the firm disposes of an asset. It receives \$10 for this disposal, but the regulatory value for the asset is only \$5. Under a regulatory values approach, this means the firm must recover the remaining value of the RAB (\$95) plus \$10, or \$105. In this circumstance, prices for the regulated assets allow the firm to recover more than the efficient resource cost of supplying the services (which was valued at \$100). This is manifestly *less* allocatively efficient (in the sense of minimising the difference between regulated prices and marginal costs of supply) than an approach which allowed recovery of the original \$100 RAB – the efficient cost.

We also do not comprehend fully the ACCC's argument that not using the regulatory values approach would result in prices changing 'for reasons other than costs changing'.³⁸ Turning this around, the ACCC is claiming that only the regulatory values approach results in prices changing due to costs changing. However, the example above shows that this does not follow because the RAB is a measure of costs incurred *in the past*, i.e. it is a repository of unrecovered value in sunk assets. For simplicity, assume the firm disposes of assets but supplies the same outputs as before the asset disposal. In the regulatory values approach prices would fall due to a falling RAB (a lower return of and on capital). There is no change in costs driving the change in RAB. Indeed, this is no different to using a regulatory payments approach which also results in a price fall – it is just that the price change may be larger, reflecting the larger reduction in (earlier recovery of) the RAB if the value of the payment exceeds the regulatory value.

³⁸ Draft decision, p. 133 (quoting the October 2014 position statement).

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