IMPUTATION TESTING REPORT RELATING TO THE ACCOUNTING SEPARATION OF TELSTRA FOR THE SEPTEMBER QUARTER 2004

December 2004

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Executive Summary

This report contains the September quarter 2004 imputation testing results prepared under the enhanced accounting separation regime for Telstra.

This is the fifth round of reporting produced in accordance with a Direction issued by the Minister for Communications, Information Technology and the Arts on 19 June 2003.

The report is intended to provide greater transparency of Telstra's operations to ensure that it does not unfairly discriminate between its own retail operations and access seekers using its network.

Imputation testing is designed to reveal whether there is a sufficient margin between Telstra's retail prices and the prices it charges access seekers to use its network (plus related costs) to enable access seekers to compete in retail telecommunications markets.

Imputation testing has been undertaken for the following retail services for, firstly, residential customers, and secondly, business customers:

- local calls and line rental
- domestic long-distance calls
- international long-distance calls
- fixed-to-mobile calls
- asymmetric digital subscriber line (ADSL) services.

Tests are conducted based on both historical and current costs. The results indicate that Telstra passes the imputation tests for domestic and international long-distance calls, fixed-to-mobile calls, and across the bundle of fixed voice telephony services. However, Telstra fails the imputation test for local call services (line rental and local calls combined) and all ADSL tests.

As this is the first set of reports that include imputation testing of ADSL services, there may be some issues of methodology that will require further attention to ensure that the tests are properly conducted. Also, it should be noted that the tests are conducted on a fully allocated cost basis and on the premise that an access seeker is no more efficient than Telstra. These initial results should be treated with some caution especially in assessing their implications for particular access seekers.

That said, Telstra reports that it fails the ADSL tests by significant margins. An initial assessment would suggest that the costs of transforming the ULLS into ADSL—and not simply the access price for the ULLS core service itself—may be the main driver of these results.

The quarterly reports for September 2003, December 2003, March 2004 and June 2004 have been audited by Ernst & Young. Ernst & Young has advised that those quarterly reports were accurate. As the reports for the September quarter 2004 have not been audited, the ACCC cannot vouch for the accuracy of these reports.

1 Introduction

On 19 June 2003, the Minister for Communications, Information Technology and the Arts (the Minister) directed the ACCC to use its record keeping rule (RKR) making powers under the *Trade Practices Act 1974* (the Act) to introduce enhanced accounting separation of Telstra.

In accordance with this Direction, the ACCC issued RKRs requiring Telstra to provide the ACCC with reports on:

- regulatory accounting statements that have been prepared on a current cost basis, in addition to reports prepared on a historical cost basis, under the Telecommunications Industry Regulatory Accounting Framework for core services (CCA reports)
- imputation analysis comparing Telstra's retail prices and the costs faced by access seekers in purchasing core services from Telstra to supply competing retail services (imputation reports)
- key performance indicators on non-price terms and conditions that compare Telstra's customer service performance between specified retail and wholesale supplied services (NPTC reports).

The Direction also requires that the ACCC publish the reports and a commentary which discusses:

- the accuracy of the reports
- the extent to which the reports comply with:
  - the Regulatory Accounting Framework (for the imputation report only)
  - any other relevant record-keeping rules made by the ACCC
  - any Direction given by the ACCC for Telstra to make public information contained in the reports.

The comments are to include any qualifications that the ACCC considers necessary.

For the imputation report, the ACCC must also summarise the results of the imputation analysis.

Telstra's CCA reports are submitted separately from this report. The Direction also requires the ACCC to provide a six-monthly report on competition in the corporate customer segment of the telecommunications market. This report is also produced separately.

The ACCC usually publishes the key performance indicators on non-price terms and conditions in the same report as the imputation testing results. However, due to delays in the audit of Telstra's non-price terms and conditions results, the ACCC will separately publish those results for the September quarter 2004.

Purpose of the reports

The Government's purpose in establishing the enhanced accounting separation framework for Telstra is to provide the ACCC, access seekers and the public with greater transparency about Telstra's wholesale and retail costs[1].

For example, it is intended to assist the ACCC in investigating conduct that may breach Part IV and Part XIB of the Act. This would include conduct such as predatory pricing, retail margin squeezing, cross-subsidisation and vertical cost shifting[2]. In such investigations it is usually important to be able to carefully distinguish between wholesale and retail costs.

Given that the ACCC remains concerned about Telstra's market power and its degree of horizontal and vertical integration, it supports measures such as the enhanced accounting separation regime that are aimed at increasing the level of transparency available to regulators, competitors and the general public.

Having said that, the ACCC considers that the enhanced accounting separation regime should be kept under review. This will ensure that it is appropriately targeted and that the anticipated benefits of enhanced accounting separation are realised. Current ACCC initiatives concerning the reports it receives from Telstra are discussed below.

Recent amendments to the RKRs

Revised RKRs were recently issued to Telstra. The revised RKRs require, either immediately or after a phasing in period:

- the preparation of CCA reports based on full current cost valuations of all major asset classes and the use of the financial capital maintenance concept
- the reporting of non price terms and conditions key performance indicators for ADSL services, and the reporting of a recurring fault metric for basic access services
- the reporting of imputation test results for the unconditioned local loop service.

Continuing consultation about the RKRs

The ACCC has a formal consultation process about the RKRs. A consultative group, the Accounting Separation Consultative Committee (ASCC), met on 14 May 2004 and 7 December 2004, and intends to continue to meet bi-annually. The ASCC enables the ACCC to provide information to industry and receive feedback from industry about the enhanced accounting separation regime. The ASCC comprises the ACCC, Telstra and other industry and user representatives.

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1 DCITA, *Draft Direction on Telstra's accounting separation issued for public comment*, media release, 19 March 2003.

2 See ACCC, *Current cost methodology for Telstra's subsequent reports under the accounting separation regime, framework document*, January 2004, p. 8-9.

2 Imputation report

2.1 Introduction to the imputation RKR

This section presents the imputation analysis of core telecommunications services supplied to access seekers. Results from previous quarters have been included to enable comparison.

On 26 June 2003 the ACCC issued an imputation RKR to Telstra. The RKR was revised on 1 September 2003 primarily as a result of Telstra advising that it could not comply with certain aspects of the rule due to data constraints. Reports provided under that rule are referred to as the initial reports.

On 29 September 2004, the ACCC issued a revised imputation RKR. Reports provided under this revised rule, which applies from the September quarter 2004 onwards, are referred to as subsequent reports.

The primary objective of the imputation RKR is to provide an indication of whether Telstra is engaging in systemic price squeeze behaviour in relation to core telecommunications services.[3]

Whether Telstra fails or passes the imputation tests does not determine whether or not Telstra has contravened the Act. Further evidence of the purpose or effect of the specific conduct is required, in addition to the other requirements of the Act. For example, a contravention of the Act would require consideration of the appropriate market definition, which may not be the same as the service descriptions used in the imputation RKR.[4]

The Direction requires that the imputation tests be made public to improve transparency about potential price squeezes for core telecommunications services.

2.2 Background

2.2.1 Vertical price squeezing

Telstra is a vertically integrated carrier that owns the delivery platform over which its services are supplied. It supplies both retail telecommunications services, such as local calls, to end users and wholesale access services to competing retail suppliers. For many telephony services, Telstra's retail competitors rely on wholesale supply from Telstra, such as access to the 'local loop' (specifically, PSTN origination and termination). The competitors then add network services (e.g. long-distance transmission for long-distance calls) and retail services (e.g. billing or call centre support).

A 'price squeeze' could occur if Telstra reduces the margin between its retail price and the wholesale access price it charges for an essential input to that retail service. Telstra could reduce

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3 Senator Alston, *Government boost to telecommunications competition*, media release, 24 September 2002.

4 For further discussion on imputation testing, refer: ACCC, *Bundling in telecommunications market—an ACCC information paper*, August 2003.

the margin by lowering the retail price for the service and/or raising the wholesale access price for the essential input.

If the difference between the wholesale access price and the retail price is not sufficient to cover Telstra's network and retail costs of supply, retail suppliers as efficient as Telstra in the supply of the retail service might not be able to remain in the market, as they would be achieving negative margins.

Imputation testing can be used to detect possible price squeezes in a retail market.

2.2.2 What are the elements of an imputation test?

An imputation test compares:

- the retail price charged by Telstra for a particular service
- the wholesale access price charged by Telstra for access to its network plus the additional costs incurred in transforming the essential input to the retail service.

Where the retail price is less than the sum of the wholesale access price and additional costs, a price squeeze is said to exist.

2.3 The imputation tests in this RKR

In this report, imputation testing is conducted on the following retail services that use Telstra's core telecommunications services as inputs:

- local calls and line rental, which use the local carriage service (LCS)
- domestic long-distance calls, which use the PSTN originating and terminating access service (PSTN O/T)
- outgoing international long-distance calls, which use the PSTN originating access service (PSTN O)
- fixed-to-mobile calls, which use the PSTN originating access service (PSTN O)
- asymmetric digital subscriber line (ADSL) services, which use the unconditioned local loop service (ULLS).

There are three main variables in an imputation test: the retail price of the retail service; the access price for the core service and the additional costs of transforming the core service into the retail service. The imputation RKR details how each variable is calculated. The results are presented in tables 2.1 – 2.4.

- The 'retail price' is the average retail price of each retail service. This is calculated by using the total revenue and volume data provided by Telstra.
- The 'access price' is the volume weighted average of the prices that Telstra charges its access seekers for the service.

- The ‘unit cost’ is the average total cost of transforming the core input into the relevant retail service. The costs of transforming the essential input are reported in two categories: ‘retail costs’ and ‘other costs’.
    - Costs are derived from the Telecommunications Industry Regulatory Accounting Framework (RAF), which allocates direct and common costs. The costs attributed to ‘retail services’ in the RAF provide the ‘retail costs’ for the imputation tests. However, there are further costs incurred in transforming a core service to a retail service, such as transmission. These are listed as ‘other costs’ in the imputation results. The tests also separate out the cost of capital and (for tests on the ULLS) ancillary charges.
    - The sum of the ‘retail costs’, ‘other costs’, ancillary charges and cost of capital, per unit of retail service, is the ‘unit cost’.
    - The imputation RKR requires Telstra to provide costs calculated on both a historical cost basis and current cost accounting basis.
    - The ACCC and Telstra have agreed to certain procedures for addressing methodological issues about costs, as outlined in section 2.6.1.

The imputed margin for each retail service can then be calculated:

- The ‘imputed margin’ is calculated by subtracting the ‘access price’ and ‘unit cost’ from the ‘retail price’ for each retail service. This represents the margin that could be available to competitors, who are equally efficient as Telstra, if supplying the retail service using Telstra’s core service.[5]
- The imputation margin as a percentage of retail price is also included in the imputation tables.

[5] As noted above, this margin is calculated after a contribution is made to ‘common costs’—that is, costs that are shared between multiple services.

2.4 Results submitted by Telstra

Table 2.1 Imputation report for September quarter 2004 on historical cost basis

	Local carriage service		Domestic PSTN originating and terminating access services		Domestic PSTN originating access service				Total Bundle of Fixed Voice Products		
	Local calls and Line rental		Domestic long distance		International long distance		Fixed to mobile		Bundle		
	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Total
Revenues											
retail	327,288,865	614,116,014	71,778,255	190,479,903	11,276,706	49,900,024	118,162,890	202,979,170	528,506,715	1,057,475,110	1,585,981,826
other	0	0	0	0	0	0	0	0	0	0	0
total	327,288,865	614,116,014	71,778,255	190,479,903	11,276,706	49,900,024	118,162,890	202,979,170	528,506,715	1,057,475,110	1,585,981,826
Retail Costs											
organisation	34,214,018	76,871,491	3,309,631	10,614,184	663,456	3,333,782	4,858,118	6,482,010	43,045,222	97,301,467	140,346,690
product and consumer	22,114,043	48,094,347	3,804,779	12,202,155	4,132,279	20,764,182	80,761,676	107,757,376	110,812,778	188,818,060	299,630,837
total	56,328,061	124,965,837	7,114,410	22,816,339	4,795,735	24,097,964	85,619,794	114,239,387	153,858,000	286,119,527	439,977,527
Other Costs											
organisation	0	0	154,986	497,050	29,575	148,609	246,682	329,138	431,242	974,797	1,406,039
product and consumer	0	0	16,816	53,930	4,633	23,280	30,977	41,332	52,426	118,542	170,968
network expenses	0	0	1,017,672	3,263,735	207,057	1,040,437	1,391,783	1,857,006	2,616,512	6,161,177	8,777,690
total	0	0	1,189,474	3,814,715	241,265	1,212,326	1,669,442	2,227,476	3,100,181	7,254,516	10,354,697
Ancillary*											
Cost of Capital	13,226,888	28,648,206	3,357,614	10,768,070	640,275	3,217,302	6,255,550	8,346,553	23,480,327	50,980,132	74,460,459
Retail Volumes**	2,553,229	5,909,105	469,084,811	1,504,383,057	24,126,679	121,233,524	350,721,417	467,954,870			
Retail price	128.1862	103.9271	0.1530	0.1266	0.4674	0.4116	0.3369	0.4338	206.9954	178.9569	187.4166
Access price	124.4845	98.0391	0.0218	0.0183	0.0101	0.0091	0.0122	0.0115	130.2636	103.7904	111.7778
Unit cost	27.2420	25.9962	0.0249	0.0249	0.2353	0.2353	0.2667	0.2667	70.6707	58.2752	62.0151
Imputed margin	-23.5402	-20.1082	0.1063	0.0835	0.2220	0.1672	0.0580	0.1555	6.0611	16.8914	13.6237
Imputed margin %	-18.3641%	-19.3484%	69.4911%	65.9366%	47.5004%	40.6269%	17.2160%	35.8488%	2.9281%	9.4388%	7.2692%

Table 2.2 ULLS report for September quarter 2004 on historical cost basis

	Unconditioned Local Loop Service			
	ADSL Service		ADSL, local calls, line rental, domestic long distance, international and FTM	
	Business	Residential	Business - 1 x ADSL Service + 4 x Voice Lines	Residential -1 x ADSL Service +1 x Voice Line
Revenues				
retail	12,091,080	32,894,152	73,279,056	75,717,982
other	0	0	0	0
total	12,091,080	32,894,152	73,279,056	75,717,982
Retail Costs				
organisation	6,381,645	19,086,934	11,365,214	22,726,475
product and consumer	9,748,422	29,156,664	22,577,787	36,219,358
total	16,130,067	48,243,598	33,943,001	58,945,833
Other Costs				
organisation	1,591,956	4,761,400	4,751,813	7,167,831
product and consumer	845,367	2,528,417	1,304,741	2,957,458
network expenses	4,859,405	14,534,049	14,198,853	22,043,333
total	7,296,728	21,823,866	20,255,407	32,168,622
Ancillary Charges (TEBA)*	1,104,220	3,302,625	1,104,220	3,302,625
Cost of Capital	4,564,736	13,652,721	16,322,842	22,560,577
Retail Volume**	73,900	221,029	73,900	221,029
Retail price	163.6137	148.8229	991.5953	342.5706
Access price	73.6900	73.6900	151.0824	103.9713
Unit cost	393.7170	393.7170	969.2194	529.2416
Imputed margin	-303.7933	-318.5841	-128.7064	-290.6423
Imputed margin %	-185.6772%	-214.0693%	-12.9797%	-84.8416%

Table 2.3 Imputation report for September quarter 2004 on current cost basis

	Local carriage service		Domestic PSTN originating and terminating access services		Domestic PSTN originating access service				Total Bundle of Fixed Voice Products		
	Local calls and Line rental		Domestic long distance		International long distance		Fixed to mobile		Bundle		
	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Total
Revenues											
retail	327,288,865	614,116,014	71,778,255	190,479,903	11,276,706	49,900,024	118,162,890	202,979,170	528,506,715	1,057,475,110	1,585,981,826
other	0	0	0	0	0	0	0	0	0	0	0
total	327,288,865	614,116,014	71,778,255	190,479,903	11,276,706	49,900,024	118,162,890	202,979,170	528,506,715	1,057,475,110	1,585,981,826
Retail Costs											
organisation	34,222,141	76,889,812	3,310,316	10,616,383	663,599	3,334,503	4,859,153	6,483,391	43,055,209	97,324,090	140,379,299
product and consumer	22,114,563	48,095,517	3,804,827	12,202,306	4,132,289	20,764,232	80,761,749	107,757,473	110,813,428	188,819,528	299,632,956
total	56,336,704	124,985,329	7,115,143	22,818,689	4,795,888	24,098,735	85,620,902	114,240,865	153,868,637	286,143,618	440,012,255
Other Costs											
organisation	0	0	129,168	414,250	26,503	133,174	8,445	11,268	164,116	558,692	722,808
product and consumer	0	0	16,218	52,013	4,562	22,923	1,309	1,746	22,089	76,683	98,772
network expenses	0	0	1,017,672	3,263,735	207,057	1,040,436	42,956	57,314	1,267,685	4,361,485	5,629,170
total	0	0	1,163,058	3,729,998	238,122	1,196,533	52,710	70,329	1,453,890	4,996,860	6,450,750
Ancillary*											
Cost of Capital	13,228,243	28,651,253	3,635,540	11,659,394	685,469	3,444,397	6,588,120	8,790,289	24,137,372	52,545,333	76,682,705
Retail Volumes**	2,553,229	5,909,105	469,084,811	1,504,383,057	24,126,679	121,233,524	350,721,417	467,954,870			
Retail price	128.1862	103.9271	0.1530	0.1266	0.4674	0.4116	0.3369	0.4338	206.9954	178.9569	187.4166
Access price	124.4845	98.0391	0.0218	0.0183	0.0101	0.0091	0.0122	0.0115	130.2636	103.7904	111.7778
Unit cost	27.2459	26.0000	0.0254	0.0254	0.2371	0.2371	0.2631	0.2631	70.2874	58.1621	61.8205
Imputed margin	-23.5442	-20.1120	0.1058	0.0829	0.2203	0.1655	0.0617	0.1592	6.4443	17.0045	13.8183
Imputed margin %	-18.3671%	-19.3521%	69.1396%	65.5119%	47.1261%	40.2019%	18.3019%	36.6922%	3.1133%	9.5020%	7.3730%

Table 2.4 ULLS tests for September quarter 2004 on a current cost basis

	Unconditioned Local Loop Service			
	ADSL Service		ADSL, local calls, line rental, domestic long distance, international and FTM	
	Business	Residential	Business - 1 x ADSL Service + 4 x Voice Lines	Residential - 1 x ADSL Service +1 x Voice Line
Revenues				
retail	12,091,080	32,894,152	73,279,056	75,717,982
other	0	0	0	0
total	12,091,080	32,894,152	73,279,056	75,717,982
Retail Costs				
organisation	6,383,552	19,092,636	11,368,276	22,733,022
product and consumer	9,748,544	29,157,029	22,577,985	36,219,779
total	16,132,095	48,249,665	33,946,261	58,952,801
Other Costs				
organisation	1,655,064	4,950,148	4,909,663	7,401,299
product and consumer	846,838	2,532,816	1,308,422	2,962,907
network expenses	4,859,407	14,534,054	14,198,858	22,043,339
total	7,361,308	22,017,018	20,416,943	32,407,545
Ancillary Charges (TEBA)*	1,104,220	3,302,625	1,104,220	3,302,625
Cost of Capital	3,888,571	11,630,370	20,848,805	24,412,777
Retail Volume**	73,900	221,029	73,900	221,029
Retail price	163.6137	148.8229	991.5953	342.5706
Access price	73.6900	73.6900	151.0824	103.9713
Unit cost	385.4686	385.4686	1032.6936	538.7340
Imputed margin	-295.5449	-310.3357	-192.1807	-300.1347
Imputed margin %	-180.6358%	-208.5269%	-19.3810%	-87.6125%

2.4.1 Notes to tables

Notes to Table 2.1 and Table 2.3 relating to fixed line telephony services:

* As per discussions with the ACCC ancillary charges are not separately reported this quarter. Currently ancillary charges are included with other costs.

** All retail volumes are reported in minutes with the exception of the local carriage service where volumes are in SIOs.

Notes to Table 2.2 and Table 2.4 relating to services supplied by the ULLS:

* As per instructions from the ACCC, ancillary charges are calculated as TEBA revenues per ULL service that are reasonably expected in a mature market. This is calculated as the TEBA revenue for the September quarter divided by the adjusted number of installed tie cable pairs. The adjustment factor set by the ACCC is 66%.

** Retail volumes are reported in terms of SIOs.

2.5 Summary of results

2.5.1 Overview

There was little difference between the imputation results based on historical cost and those based on current cost. Current cost accounting adjusts historical cost data to allow for cost variations in respect of depreciation and cost of capital to Telstra's fixed assets. However, as imputation tests use the access price instead of Telstra's actual cost of supplying the core service using its fixed assets, the current cost imputed margins are unlikely to significantly differ from historical cost margins.

While the ACCC has provided the imputation results for both historical and current cost, the ensuing discussion focuses on the historical cost results.

The imputation RKR uses average total cost in calculating the cost of transforming Telstra's core service into a retail service. The ACCC believes that this measure provides an important indicator of the long-run impacts of particular pricing.[6]

The ACCC notes that implementing an imputation test of this nature requires assumptions being made and that data constraints may limit Telstra's ability to fully report on some matters. While the ACCC and Telstra are working to improve data availability and ensure that assumptions on which tests have been constructed remain relevant and appropriate, the reported results will need to be qualified, at least in the interim.

Table 2.5 provides an overview of the imputation test results. The results show that Telstra passes the imputation tests for domestic and international long-distance calls, fixed-to-mobile calls, and across the bundle of fixed voice products. However, Telstra fails for line rental and local calls, ADSL services and bundles containing ADSL and fixed voice products.

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[6] The ACCC has discussed this issue in its *Bundling in telecommunications markets* report, fn 4.

Table 2.5 Imputation testing undertaking on a historical cost basis

			Imputed margin (by quarter)					
Retail service	**Core service(s)**		**Sep 03***	**Dec 03**	**Mar 04**	**Jun 04**	**Sep 04**	**Result**
Local calls and line rental	LCS	Business	-9%	-10%	-16%	-17%	-18%	Fail
		Residential	-8%	-8%	-17%	-13%	-19%	Fail
Domestic long-distance	PSTN O/T	Business	64%	64%	65%	66%	69%	Pass
		Residential	58%	59%	60%	61%	66%	Pass
International long-distance	PSTN O	Business	40%	24%	49%	49%	48%	Pass
		Residential	24%	22%	36%	37%	41%	Pass
Fixed-to-mobile	PSTN O	Business	21%	19%	15%	14%	17%	Pass
		Residential	36%	36%	32%	34%	36%	Pass
Bundle of fixed voice services#	LCS & PSTN O/T	Business	11%	8%	5%	4%	3%	Pass
		Residential	15%	15%	10%	12%	9%	Pass
		Total	13%	13%	8%	9%	7%	Pass
ADSL	ULLS	Business	-	-	-	-	-186%	Fail
		Residential	-	-	-	-	-214%	Fail
Bundle of ADSL and all fixed voice services	ULLS & PSTN T	Business^	-	-	-	-	-13%	Fail
		Residential	-	-	-	-	-85%	Fail

* Telstra provided revised margins for the September 2003 quarter in May 2004.
# The bundle of fixed voice services comprises of locals calls and line rental, domestic and international long-distance and fixed-to-mobile calls.
^ The bundle for business customers contains one ADSL service and four bundles of fixed voice services.

The results for fixed voice products are broadly consistent with the results from previous quarters.

Some small changes in imputed margins between September 2004 and June 2004 quarters may partly be explained through changes to the underlying cost base—from the July–December 2003 RAF data to the January–June 2004 RAF data. This is discussed in section 2.6.

The largest change is an approximately 6% decrease in the result for residential local calls and line rental from –13% to –19%. This appears to have occurred because of an increase in the volume weighted average access price for the local carriage service. There was also a 5% increase in the margin for residential domestic long-distance calls driven by a combination of a slight increase in the retail price and slight decreases in the access price and unit costs.

Margins have also increased on fixed-to-mobile services. For this quarterly report, Telstra has been able to identify revenues and volumes that originate on ISDN services instead of PSTN services, and has excluded these from the imputation test. This resulted in slight increases in the retail prices for fixed-to-mobile calls. As the majority of ISDN calls are from business customers, the business margins are more sensitive to the change. The revenues and volumes for local and long-distance calls from ISDN services had already been excluded from the imputation tests.

Margins generally increased on domestic and international long-distance calls and fixed-to-mobile call services. However margins fell for local calls and line rental services and on the overall bundle.

Telstra fails all imputation tests that use the ULLS as a core input by significant margins. This is discussed in sections 2.5.5 and 2.5.6 below.

2.5.2 Line rental and local calls

The results indicate that Telstra would receive a negative margin if it supplied the grouped local call and line rental retail services by purchasing the LCS input at arms' length from itself. Telstra has achieved 'fails' for the local call and line rental services in all imputation reports.

These results could be seen as raising price squeeze concerns. However, failure of an imputation test does not necessarily show a contravention of the Act.

The ACCC does not regard the failures for the local call and line rental retail product as being a concern at this stage.

The first reason for this view is that positive margins on long-distance calls may mean that competing retail providers could recover the loss on line rental and local calls from their long-distance and fixed-to-mobile businesses. The positive margins on the bundles of line rental, local calls, long-distance and fixed-to-mobile calls tend to support this proposition. The ACCC has previously noted in its *Final determination for model price terms and conditions for the PSTN, ULLS and LCS* that:

> The Commission's imputation analysis indicated that there is cross-subsidisation of Telstra's local call services [consisting of line rental, local and neighbourhood calls] from its long distance services. However, the existence of positive margins on the long distance services which more than offset the negative margins on local call services means that Telstra's retail local call prices are not considered predatory because access seekers should be able to emulate this cross-subsidisation.[7]

The ACCC understands that access seekers would aim to supply long-distance and fixed-to-mobile calls to customers in addition to providing local calls.

Secondly, the ACCC uses 'unbundled' local call retail prices in a 'retail minus' methodology to determine the access price for the LCS. Local call retail prices can be for local calls as part of a bundle of retail service offerings, or for stand-alone local calls (i.e. unbundled prices). These unbundled prices might be expected to be higher than the average retail prices used in the imputation test. This may make an imputation test failure for the local call and line rental retail service more likely.

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[7] ACCC, *Final determination for model price terms and conditions for the PSTN, ULLS and LCS services*, October 2003, p. 101.

That said, and as stated in previous reports, the ACCC will review the LCS declaration and associated pricing principles and would intend to consider this matter further in light of information made available in the course of that inquiry.[8]

The ACCC also notes that the imputed margin for local calls and line rental for residential customers may be understated because of the inclusion of Telstra's 'InContact' product. This product can be used to receive calls and to make calls to a limited range of services including emergency numbers, service difficulties and faults. The ACCC understands that InContact represents only a small proportion of Telstra's customers.[9] Nonetheless, its inclusion may slightly reduce the margin in the imputation test for local calls and line rental services.

2.5.3 Domestic and international long-distance and fixed-to-mobile calls

In the retail supply of domestic and international long-distance and fixed-to-mobile calls, Telstra would make a positive margin if it purchased the essential input, the domestic PSTN originating and terminating access, at arms' length from itself.

Telstra's margins vary significantly between the three retail services, with the highest margins being achieved on domestic long-distance calls, then international long-distance and then fixed-to-mobile calls.

The margins also vary between business and residential retail services. Margins on business long-distance calls are higher than residential long-distance calls, but lower on business fixed-to-mobile calls compared with residential fixed-to-mobile calls.

It should be noted that as the RAF does not disaggregate costs between customer groups, there are no differences between the unit costs for residential and business customers. The differences in margin are therefore largely due to differences in the retail prices.

The ACCC also notes that all fixed-to-mobile calls are assumed to be terminated off-net. As the cost of terminating calls is considered less than that currently charged by mobile operators for the mobile terminating access service, to the extent that an access seeker can supply on-net fixed-to-mobile calls, the margins will be understated. This qualification is also relevant to the bundles that include fixed-to-mobile calls.

2.5.4 Bundle of fixed voice services

Imputation tests have also been undertaken on bundles of fixed voice services, comprising of local calls, line rental, domestic and international long-distance calls and fixed-to-mobile calls. Telstra passed the test for the bundles with a margin of 9% for residential customers and 3% for business customers.

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8 Telstra proposed access undertakings to the ACCC in respect of the LCS but only for the period ending 30 June 2005. The ACCC has accepted these undertakings. This does not effect the ACCC's intentions to undertake a wider review of the LCS, as outlined in those reports.

9 InContact is only available to non-business customers, holding an eligible concession card, at private dwellings where no other access service is provided to the dwelling or customer.

2.5.5 ADSL

From this quarter onwards, imputation tests will be conducted on services that use the ULLS as a core service input. The results indicate that in the retail supply of ADSL, Telstra would make a significantly negative margin if it purchased the essential input, the ULLS, at arms' length from itself.

Table 2.5 indicates that a margin of –214% would be incurred in supplying the ADSL service to residential customers, and –186% to business customers.

The driver of the significant fail margins is the costs incurred in supplying ADSL that are additional to the purchase of the ULLS core service. Table 2.2 shows that an access seeker supplying an ADSL service to a residential customer would per month, on average, receive $55 of revenue, pay $25 for the ULLS and incur $131 of costs in transforming the ULLS service into the retail ADSL service.

In assessing the cost aspects of the reported results, the following factors should be considered:

- The imputation test uses the average total cost of transforming the ULLS into ADSL, which assumes that ADSL over the ULLS would make a pre-determined contribution to an access seekers common costs.[10] Telstra has indicated to the ACCC that access seekers would be unlikely to make such a contribution to overheads and common costs given that ADSL has not reached sufficient maturity. The ACCC notes that the maturity of the market, or otherwise, is debatable given that ADSL has been offered since August 2000 and that over 1 million customers acquire broadband services.[11]

- A further aspect of this is the extent to which Telstra's product and overhead costs are an accurate representation of those costs faced by access seekers who are targeting niche areas and customers, particularly in the business/corporate segment.

- The method for calculating TEBA charges assumes a mature level of utilisation of the ULLS, estimated at 66 per cent of tie copper pairs that have been installed in Telstra's exchanges. Therefore, the results will understate the TEBA charges per ULLS customer supplied until the access seekers reaches the nominated mature level of utilisation. Some elements of these charges may however be captured in the RAF cost categories, leading to some double counting.

- The test excludes costs associated with the installation, removal or connection of equipment in relation to customer premise equipment. If access seekers subsidise these costs to acquire customers, the actual margins would be less (i.e. more negative) than those reported.

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10 It should be noted that the ACCC assessment of the price squeeze allegations regarding the pricing of wholesale ADSL did not use RAF information, although the RAF has been used as a limited cross-check for other information provided.

11 Telstra, *Telstra Wholesale shows significant broadband growth*, media release, 19 October 2004.

In considering the difference in results between customer groups, the following factors should also be considered:

- the customer groups are currently determined on the basis of unaudited survey data collected by Telstra when the ADSL service is first connected to the customer[12]
- the revenues for BigPond services are averaged across customer groups rather than allocated directly to each. If one class of customers generally subscribes to higher priced BigPond plans, the reported results would understate the revenues earned from that customer group and overstate the revenues received from the other customer group
- as the RAF does not disaggregate costs between customer groups, the costs are averaged over each customer group's demand for the service.

The ACCC notes that the test focuses on the use of ULLS to supply ADSL, but other wholesale inputs may used, including wholesale ADSL services (although the pricing of this wholesale service is currently subject to a Competition Notice). Additionally, use of the ULLS core service enables other retail services to be supplied in conjunction with ADSL. The provision of other services, such as SHDSL, may yield significantly higher revenues per quarter than ADSL services.

Notwithstanding the qualifications above (which could mean that actual margins are either more or less than those reported under the current imputation test) the results appear to strongly indicate that any business model involving the use of ULLS to supply only ADSL to customers is likely to be flawed. The tests involving a combination of ADSL and voice services may therefore more accurately reflect current market conditions.

2.5.6 Bundles of ADSL and fixed voice services

Imputation tests have been undertaken on bundles of ADSL and fixed voice services, (comprising of local calls, line rental, domestic and international long-distance calls and fixed-to-mobile calls). Telstra fails the tests for both residential and business customers.

The test on the bundle for residential customers, which consists of one ADSL service and one voice service, fails with a margin of -88 per cent. The test on the bundle for business customers services, comprising one ADSL service and four voice services, fails with a margin of -13 per cent.

The factors outlined in section 2.5.5 and the qualification regarding fixed-to-mobile calls in section 2.5.3 are also relevant for these tests.

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12 The ACCC has concerns about the robustness of this approach and Telstra has undertaken to implement system changes to enable allocation of customers on the basis of the line rental charged on the underlying line rental service. These changes should be implemented in time for the June quarter 2005 report.

In addition, the imputation test assumes that the costs of supply of the voice services in this bundle would be in line with costs of supply of voice services over the PSTN. Service providers wishing to supply voice services and broadband services over the PSTN could choose to do so voice over broadband/data/IP alternatives—this may result in significantly lower costs than those reported in the current tests.

The ACCC again notes that these tests focus on the use of ULLS to supply ADSL and voice services, but that other wholesale inputs may used. Additionally, use of the ULLS core service enables other retail services to be supplied, which are not limited to ADSL and the aforementioned voice services.

That said, the results indicate that in the absence of market developments, the use of the ULLS to supply competitive services will likely be limited to areas in which costs of supply are lower and/or are able to be directed to customers that yield higher revenues per service supplied, as compared to the average revenue and cost estimates used in these tests, such as medium and large business enterprises.

Market developments that could expand the scope of services that could reasonably be expected to be supplied would include the supply of other services over the ULLS (e.g. pay TV, higher speed/quality DSL services, other multi-media services), or reductions in access prices or other cost inputs.

The results of these imputation tests indicate that it is not simply the access price of the ULLS that is likely to be driving the negative results—this is because the costs involved in transforming the ULLS into ADSL are of much higher magnitude than the access price. This may suggest that the ACCC should focus greater attention towards identifying any cost and non-cost barriers to use of the ULLS.

Finally, as this is the first time this test has been used, the ACCC anticipates that the test will need to be further scrutinised and refined to ensure it is as accurate and realistic of access seekers’ circumstances as possible.

2.6 Reconciling imputation RKR data with the RAF

2.6.1 Background

Telstra prepares its imputation reports each quarter. In doing so, it uses revenue and volume data to obtain the retail price and access price, and uses RAF data to obtain unit costs.

Ideally, the imputation test results would be based on retail price, access price and unit cost figures appropriate to the quarter. Telstra is able to obtain retail price and access price data from its management systems on a quarterly basis. However, the RAF is only published twice a year, and is not available until after the imputation testing results must be submitted to the ACCC. Imputation testing is therefore conducted using cost data from the previous half-year's RAF reports.[13]

The reconciliation report is designed to check whether the use of this lagged data affects the results of the imputation tests, and whether the quarterly reports are presenting a reasonable estimate of the actual imputation margins available in a particular quarter. It compares the results shown in the quarterly reports, using the management system and lagged RAF data, to the results using revenue, volume and cost data from the RAF appropriate to the test period.

2.6.2 Summary of reconciliation results

Telstra provided the ACCC with reconciliation results on 30 November 2004. It provided the following information:

- an aggregate of the quarterly reports for the March and June quarters 2004, which relied on the cost information in the July–December 2003 RAF

- a report for the period January to June 2004, using the revenues, volumes and costs from the half-yearly RAF report for January–June 2004.

The reports were provided on both a historical and current cost accounting basis. These results are provided in section 2.6.3.

For both sets of data, the retail price, access price, unit costs and imputed margin were calculated. Table 2.6 shows the differences in results for the tests conducted on a historical cost basis.

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13 For example, in the results for the June quarter 2004, the unit cost data was obtained from the July to December 2003 RAF. The current report for the September quarter 2004 uses data from the January to June 2004 RAF.

Table 2.6 Reconciliation report results on a historical cost basis

Retail service	Core service(s)		Imputed margin for aggregated test (using Jul-Dec 03 RAF)	Imputed margin using RAF data (Jan-Jun 04 RAF)
Local calls and line rental	LCS	Business	-16%	-18.5%
		Residential	-14.8%	-18.1%
Domestic long-distance	PSTN O/T	Business	65.5%	68%
		Residential	60.5%	64%
International long-distance	PSTN O	Business	48.9%	51.6%
		Residential	36.8%	40.1%
Fixed-to-mobile	PSTN O	Business	14.5%	13.5%
		Residential	32.8%	32%
A bundle of all of the above services	LCS and PSTN O/T	Business	4.3%	3%
		Residential	11.2%	10%
		Total	8.7%	7.5%

Table 2.6 shows some differences in the margins between the aggregated quarterly reports and the report prepared using January–June 2004 RAF data. The ACCC notes the following differences in the report using the January–June 2004 RAF compared to the aggregated quarterly reports:

- decreases in margins for the combined local call and line rental product (of around 3%) and fixed-to-mobile calls (around 1%)
- increases in margins for domestic long-distance (around 3%) and international long-distance calls (around 3%)
- decreases in margins for the overall bundle of services (around 1.2%).

The margins based on current cost had smaller increases for domestic and international long-distance (around 0% and 1% respectively), and slightly larger decreases of around 2% for the overall bundle. The following discussion is based on the results for the historical cost data.

Differences in revenues and volumes

There are some differences between the revenues in the aggregated quarterly report and the revenues obtained from the January–July 2004 RAF data. The differences are summarised in Table 2.7.

Table 2.7 Differences in revenues between the aggregated reports and the RAF

	Aggregated quarterly reports	January to July 2004 RAF	Difference	Percentage difference
Line rental and local calls	$1,861,283,279	$1,893,072,737	$31,789,458	1.71%
Domestic long-distance	$539,139,828	$550,762,107	$11,622,280	2.16%
International	$127,858,407	$130,947,247	$3,088,839	2.42%
Fixed-to-mobile	$775,614,058	$789,453,353	$13,839,295	1.78%
Bundle of all services	$3,303,895,572	$3,364,235,444	$60,339,872	1.83%

Telstra has advised the ACCC that the differences mainly arise as a result of different accounting principles in the RAF and the imputation RKR. Telstra noted that the imputation RKR only includes revenues from Telstra's retail business units, while the RAF includes revenues from Telstra's wholesale unit and corporate centre.

There are also differences between the volumes reported in the aggregated quarterly reports and the volumes from the January–June 2004 RAF. Telstra reports that the volumes from the January–June 2004 RAF, compared to the aggregated quarterly reports, are 2% higher for line rentals, around 0.7% higher for local calls, around 0.8% higher for domestic long-distance, 0.3% lower for international long-distance and 3% higher for fixed-to-mobile calls.

Telstra attributes these differences to:

- the inclusion of Telstra's internal access lines, call number and minutes in the RAF figures
- the imputation report line rental figures being averaged across three months while the RAF line rental figures are averaged over six months
- the RAF including national operator assisted and national reverse charged calls in domestic-long distance volumes, while the imputation report does not
- the RAF including outbound international operator assisted, international reverse charged and Australia direct calls in the international volumes, while the imputation report does not.

Differences in costs

The quarterly reports use lagged RAF data to obtain retail cost and hence unit cost figures. As such, the reconciliation report shows any difference between the costs in the RAF for the six-month reporting period preceding each quarter, and the RAF for the relevant six-month reporting period.

Telstra has advised that there were a number of changes to costs between the July–December 2003 and January–June 2004 RAF reports:

- Unit costs for line rental increased over the period. This was driven by a large increase in sales and marketing expenses and an increase in general administration expenditures, coupled with a decrease in the number of lines.

- Unit costs for local calls increased over the period. Although there was a large reduction in information technology expenses, this was offset by a large increase in the retail cost of capital and a decline in the number of local calls. Tables 2.8 and 2.9 show the unit costs associated with the local call and line rental product increased by 14%.

- Total costs declined for both domestic and international long-distance calls. The decrease in domestic costs was due to a decline in general administration and IT costs. The decline in international long-distance costs was because of a drop in IT costs and reductions in international settlement rates. The results show that there was a decrease in unit costs of around 11% for domestic long distance and 3% for international long distance.

- Total costs increased for fixed-to-mobile calls, due to an increase in the retail cost of capital and product and customer costs offsetting decrease in general administration and IT costs. The results show that fixed-to-mobile unit costs did not change significantly.

The differences in the unit costs derived from the two RAF reports have affected the margins in the imputation tests as described above. The margins obtained using the January–June 2004 RAF data are arguably a more accurate example of the actual imputation margins experienced over the January–June 2004 period than the aggregated imputation reports.

2.6.3 Reconciliation results submitted by Telstra

Table 2.8 Aggregated quarterly report for January to June 2004 on historical cost basis (using July-December 2003 RAF costs)

	Local carriage service		Domestic PSTN originating and terminating access services		Domestic PSTN originating access service				Total Bundle of Fixed Voice Products		
	Local calls and Line rental		Domestic long distance		International long distance		Fixed to mobile		Bundle		
	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Total
Revenues											
retail	669,200,749	1,192,082,530	144,695,282	394,444,546	23,484,651	104,373,756	362,857,929	412,756,128	1,200,238,612	2,103,656,960	3,303,895,572
other	0	0	0	0	0	0	0	0	0	0	0
Total	669,200,749	1,192,082,530	144,695,282	394,444,546	23,484,651	104,373,756	362,857,929	412,756,128	1,200,238,612	2,103,656,960	3,303,895,572
Retail Costs											
organisation	66,433,909	149,125,202	8,935,895	29,989,036	1,838,956	10,155,433	19,519,206	17,475,742	96,727,966	206,745,413	303,473,378
product and	57,580,752	126,724,346	11,481,047	38,530,614	8,611,390	47,555,455	263,760,212	236,147,180	341,433,400	448,957,596	790,390,996
Total	124,014,660	275,849,547	20,416,941	68,519,650	10,450,346	57,710,889	283,279,418	253,622,922	438,161,366	655,703,009	1,093,864,374
Other Costs											
organisation	0	0	674,436	2,263,421	103,488	571,501	1,888,993	1,691,235	2,666,917	4,526,157	7,193,074
product and	0	0	34,144	114,588	8,022	44,299	93,885	84,056	136,050	242,943	378,994
network	0	0	5,621,195	18,864,840	889,651	4,913,002	9,967,854	8,924,320	16,478,701	32,702,162	49,180,863
Total	0	0	6,329,776	21,242,849	1,001,161	5,528,802	11,950,732	10,699,611	19,281,669	37,471,263	56,752,931
Retail price	256.4248	197.5039	0.1517	0.1232	0.4963	0.3994	0.3292	0.4182	459.9083	348.5333	382.1531
Access price	249.9761	181.0582	0.0243	0.0206	0.0114	0.0103	0.0137	0.0131	264.8520	194.5526	215.7733
Unit cost	47.5200	45.7027	0.0280	0.0280	0.2420	0.2420	0.2678	0.2678	175.2834	114.8449	133.0889
Imputed margin	-41.0713	-29.2570	0.0993	0.0746	0.2428	0.1471	0.0477	0.1373	19.7729	39.1358	33.2909
Imputed margin %	-16.0169%	-14.8134%	65.4889%	60.5397%	48.9344%	36.8429%	14.4784%	32.8405%	4.2993%	11.2287%	8.7114%

Table 2.9 Report for January to June 2004 on historical cost basis (using January-June 2004 RAF costs)

	Local carriage service		Domestic PSTN originating and terminating access services		Domestic PSTN originating access service				Total Bundle of Fixed Voice Products		
	Local calls and Line rental		Domestic long distance		International long distance		Fixed to mobile		Bundle		
	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Total
Revenues											
retail	681,296,405	1,211,776,332	147,814,490	402,947,618	24,052,000	106,895,246	369,332,410	420,120,943	1,222,495,305	2,141,740,139	3,364,235,444
other	0	0	0	0	0	0	0	0	0	0	0
Total	681,296,405	1,211,776,332	147,814,490	402,947,618	24,052,000	106,895,246	369,332,410	420,120,943	1,222,495,305	2,141,740,139	3,364,235,444
Retail Costs											
organisation	71,048,484	160,649,274	6,781,358	22,758,367	1,297,500	7,165,303	15,730,104	14,083,321	94,857,446	204,656,265	299,513,711
product and	73,067,230	160,973,662	12,245,357	41,095,656	8,941,269	49,377,177	278,723,833	249,544,261	372,977,690	500,990,756	873,968,446
Total	144,115,714	321,622,935	19,026,715	63,854,024	10,238,770	56,542,480	294,453,937	263,627,582	467,835,136	705,647,021	1,173,482,157
Other Costs											
organisation	0	0	411,785	1,381,960	71,145	392,890	1,133,808	1,015,110	1,616,738	2,789,960	4,406,698
product and	0	0	34,456	115,634	9,061	50,036	100,301	89,800	143,817	255,471	399,288
network	0	0	4,421,187	14,837,588	783,899	4,328,998	8,307,384	7,437,685	13,512,471	26,604,272	40,116,743
Total	0	0	4,867,428	16,335,182	864,105	4,771,925	9,541,493	8,542,595	15,273,026	29,649,703	44,922,729
Retail price	255.9893	196.8674	0.1538	0.1249	0.5098	0.4102	0.3252	0.4132	459.3385	347.9510	381.5745
Access price	249.1313	180.3245	0.0244	0.0206	0.0114	0.0103	0.0137	0.0131	263.9968	193.7168	214.9316
Unit cost	54.1498	52.2514	0.0249	0.0249	0.2353	0.2353	0.2677	0.2677	181.5223	119.4576	138.1926
Imputed margin	-47.2919	-35.7086	0.1046	0.0795	0.2630	0.1647	0.0438	0.1324	13.8194	34.7766	28.4504
Imputed margin %	-18.4742%	-18.1384%	67.9876%	63.6084%	51.5935%	40.1403%	13.4671%	32.0480%	3.0085%	9.9947%	7.4561%

Table 2.10 Aggregated quarterly report for January to June 2004 on current cost basis (using July-December 2003 RAF costs)

	Local carriage service		Domestic PSTN originating and terminating access services		Domestic PSTN originating access service				Total Bundle of Fixed Voice Products		
	Local calls and Line rental		Domestic long distance		International long distance		Fixed to mobile		Bundle		
	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Total
Revenues											
retail	669,200,749	1,192,082,530	144,695,282	394,444,546	23,484,651	104,373,756	362,857,929	412,756,128	1,200,238,612	2,103,656,960	3,303,895,572
other	0	0	0	0	0	0	0	0	0	0	0
Total	669,200,749	1,192,082,530	144,695,282	394,444,546	23,484,651	104,373,756	362,857,929	412,756,128	1,200,238,612	2,103,656,960	3,303,895,572
Retail Costs											
organisation	65,026,122	145,954,496	8,763,428	29,410,232	1,805,103	9,968,480	19,115,428	17,114,235	94,710,079	202,447,444	297,157,523
product and	57,049,406	125,527,615	11,415,952	38,312,155	8,598,613	47,484,893	263,607,812	236,010,735	340,671,782	447,335,399	788,007,181
Total	122,075,527	271,482,111	20,179,379	67,722,387	10,403,715	57,453,374	282,723,240	253,124,971	435,381,862	649,782,843	1,085,164,704
Other Costs											
organisation	0	0	220,423	739,744	46,043	254,268	1,427,618	1,278,161	1,694,084	2,272,173	3,966,257
product and	0	0	2,485	8,339	3,614	19,959	52,987	47,440	59,087	75,739	134,825
network	0	0	3,547,846	11,906,638	657,927	3,633,331	9,061,712	8,113,042	13,267,484	23,653,011	36,920,495
Total	0	0	3,770,754	12,654,722	707,585	3,907,558	10,542,317	9,438,643	15,020,655	26,000,923	41,021,578
Retail price	256.4248	197.5039	0.1517	0.1232	0.4963	0.3994	0.3292	0.4182	459.9083	348.5333	382.1531
Access price	249.9761	181.0582	0.0243	0.0206	0.0114	0.0103	0.0137	0.0131	264.8520	194.5526	215.7733
Unit cost	46.7770	44.9791	0.0251	0.0251	0.2348	0.2348	0.2660	0.2660	172.5856	111.9637	130.2631
Imputed margin	-40.3283	-28.5334	0.1023	0.0775	0.2500	0.1543	0.0494	0.1391	22.4707	42.0170	36.1168
Imputed margin %	-15.7271%	-14.4470%	67.4216%	62.9191%	50.3831%	38.6429%	15.0198%	33.2666%	4.8859%	12.0554%	9.4509%

Table 2.11 Report for January to June 2004 on current cost basis (using January-June 2004 RAF costs)

	Local carriage service		Domestic PSTN originating and terminating access services		Domestic PSTN originating access service				Total Bundle of Fixed Voice Products		
	Local calls and Line rental		Domestic long distance		International long distance		Fixed to mobile		Bundle		
	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Total
Revenues											
retail	681,296,405	1,211,776,332	147,814,490	402,947,618	24,052,000	106,895,246	369,332,410	420,120,943	1,222,495,305	2,141,740,139	3,364,235,444
other	0	0	0	0	0	0	0	0	0	0	0
Total	681,296,405	1,211,776,332	147,814,490	402,947,618	24,052,000	106,895,246	369,332,410	420,120,943	1,222,495,305	2,141,740,139	3,364,235,444
Retail Costs											
organisation	71,065,360	160,687,547	6,782,762	22,763,082	1,297,781	7,166,853	15,733,455	14,086,321	94,879,358	204,703,803	299,583,162
product and	73,071,126	160,982,473	12,245,708	41,096,831	8,941,339	49,377,560	278,701,966	249,524,683	372,960,137	500,981,547	873,941,684
Total	144,136,486	321,670,020	19,028,470	63,859,913	10,239,120	56,544,413	294,435,421	263,611,004	467,839,496	705,685,351	1,173,524,846
Other Costs											
organisation	0	0	358,298	1,202,456	64,715	357,380	424,153	379,749	847,166	1,939,584	2,786,750
product and	0	0	33,231	111,524	8,922	49,269	4,238	3,794	46,390	164,587	210,978
network	0	0	4,990,983	16,749,835	872,657	4,819,152	4,954,495	4,435,809	10,818,134	26,004,796	36,822,931
Total	0	0	5,382,512	18,063,815	946,293	5,225,801	5,382,885	4,819,352	11,711,691	28,108,968	39,820,659
Retail price	255.9893	196.8674	0.1538	0.1249	0.5098	0.4102	0.3252	0.4132	459.3385	347.9510	381.5745
Access price	249.1313	180.3245	0.0244	0.0206	0.0114	0.0103	0.0137	0.0131	263.9968	193.7168	214.9316
Unit cost	54.1576	52.2591	0.0254	0.0254	0.2371	0.2371	0.2640	0.2640	180.1858	119.2135	137.6187
Imputed margin	-47.2997	-35.7163	0.1040	0.0789	0.2612	0.1629	0.0475	0.1361	15.1559	35.0206	29.0242
Imputed margin %	-18.4772%	-18.1423%	67.6379%	63.1779%	51.2503%	39.7138%	14.5981%	32.9382%	3.2995%	10.0648%	7.6064%

2.7 Extent to which the reports comply with the RAF and other RKRs

The Ministerial Direction requires the ACCC to comment on the extent to which the reports comply with:

- the RAF
- any other relevant record-keeping rules made by the ACCC (whether for the purposes of the Minister's Direction or otherwise)
- any Direction given by the ACCC for Telstra to make public information contained in the reports.

This section discusses the extent to which the reports comply with the RAF.

2.7.1 Relationship between the RAF and the imputation RKR

Telstra provides financial information to the ACCC in the RAF. Under the RAF, Telstra must provide capital adjusted profit and loss statements for its retail services, internal wholesale services and external wholesale services. Telstra must also provide capital employed and fixed asset statements for those three services.

The Ministerial Direction requires that Telstra provide the imputation RKR information to the ACCC each quarter. Telstra currently provides RAF information to the ACCC every six months. To address this time disparity, the ACCC requires Telstra to:

- obtain revenue information for core and retail services for the relevant quarter from Telstra's general ledger accounts
- obtain volume information for core and retail services for the relevant quarter from Telstra's management information systems
- obtain cost information for retail services each quarter by multiplying the volume data for the relevant quarter with the unit costs of the service derived from the RAF accounts for the six-month reporting period preceding that quarter.

The RAF records volume information for retail and core services. The imputation RKR requires Telstra to use volume data for retail services from the RAF for the previous six-months to unitise cost information. It also requires volume data for the relevant quarter be used, and this can later be compared to the volume data that appears in the RAF.[14]

[14] The ACCC has released some volume information pursuant to section 151BUA of the Act. See, for example, ACCC, *Telecommunications market indicator report 2002-03* (June 2004).

The ACCC notes that the RAF does not disaggregate data between business and residential customer groups.

2.7.2 Revenue differences between the imputation RKR and the RAF

The RAF allocates revenues across various retail services. The imputation RKR requires Telstra to allocate its retail revenues in a manner consistent with the RAF. This allows for the reports provided by Telstra to be reconciled with the RAF data in future periods.

The ACCC has noted one relevant difference between the revenues that Telstra extracts from its general ledger for the imputation RKR and those included in the RAF. The definition for the domestic long-distance service in the imputation RKR excludes revenues from operator assisted calls, which are included in the corresponding RAF category. Therefore, the domestic long-distance revenues in the RKR will be lower than the RAF revenue for the national long-distance retail service.

The revenues for line rental, local calls, international long-distance, fixed-to-mobile calls and ADSL in the imputation RKR are consistent with the revenues items for these services in the RAF.

2.7.3 Cost differences between the imputation RKR and the RAF

The RAF allocates common costs as well as direct costs to wholesale and retail services. The costs attributed to retail services in the RAF are appropriate for calculating ‘retail costs’ for the imputation test, but do not include all costs in the transformation of a core service to a retail service (such as transmission). Therefore, the additional costs are listed separately as ‘other costs’ in Telstra’s imputation testing results.

Telstra uses unitised cost information from the RAF reports from the preceding six-monthly reporting period, which is multiplied by the volume for the relevant quarter. This cost information is later reconciled with the RAF. In constructing the imputation test under the current RKR, Telstra raised four implementation issues relating to the calculation of appropriate retail and other costs using the RAF data. Telstra sought the ACCC’s agreement on the way to resolve these issues. The ACCC agreed that the implementation issues existed and needed rectification, and that the proposed methods appeared reasonable.

The issues identified by Telstra, and the agreed solutions, have resulted in some adjustments to the RAF figures in the imputation test. The adjustments relate to:

- the removal of installation costs from the cost of line rental and ADSL—as required by the imputation RKR
- the removal of modem costs from the cost of ADSL—implied from the definition of ADSL in the imputation RKR
- the use of a mobile termination methodology for costing fixed-to-mobile services

- avoiding the double-counting of ULLS and PSTN originating and terminating access service costs

- adjustment to call costs used in the bundle of ADSL and fixed voice products when services are provided over the ULLS

- ancillary costs for the ULLS.

The latter four dot points are described in more detail below.

The ACCC also notes that Telstra has included the retail and wholesale costs of capital in the imputation tests. The WACC used in calculating the cost of capital is that set out in Telstra’s RAF. In its RAF for the six months to June 2004, Telstra used an annual WACC figure of 14.75%. Should Telstra have used the ACCC’s WACC, then Telstra’s calculated costs would have been lower and, as such, the imputed margins would have been higher.

Mobile termination methodology for fixed-to-mobile services

As the imputation tests are designed to show whether an efficient access seeker is able to compete with Telstra, the imputation test needed adjustment to account for Telstra’s on-net fixed-to-mobile calls. The ACCC and Telstra agreed that Telstra impute the weighted average mobile termination charge that would apply to an access seeker which terminates fixed-to-mobile traffic on Telstra’s mobile network.

Double-counting ULLS and PSTN originating and terminating costs

To calculate the costs of transforming the PSTN and ULLS core services into the retail services specified in the imputation RKR, Telstra uses its Retail and Internal Wholesale accounts in the RAF. However, the Internal Wholesale accounts include costs of network elements and functions that are already captured in the access prices for the PSTN O/T and ULLS. For example, the Internal Wholesale costs recorded in the RAF allocate local switching and transmission costs to the domestic long-distance service, which are already factored into the PSTN access price.

To overcome this issue, Telstra deducted the common elements located in the External Wholesale accounts (which are used to calculate the access price) from the costs located in the Internal Wholesale accounts in the RAF.

Non-ULLS call costs

For the bundled tests involving ADSL and fixed voice products, the costs for origination and termination for fixed telephony calls change when the underlying service is ULLS.

The ACCC and Telstra have agreed to a methodology that involves several steps. For local and domestic long-distance calls, the PSTN TA network costs are removed from the RAF and PSTN TA charges are added, using a similar method to that used to remove double-counted costs. For international long-distance calls, the international settlement payments are used for termination of such calls. For fixed-to-mobile calls, the methodology explained above for mobile termination is used.

Ancillary charges for the ULLS

The imputation RKR requires Telstra to calculate ancillary charges for the ULLS, in particular, Telstra Exchange Building Access charges. The imputation reports at this stage may double count some aspects of the TEBA charges in both ancillary and cost categories.

2.7.4 Conclusion on the extent to which the reports comply with the RAF

Subject to the exceptions noted in sections 2.7.2 and 2.7.3, the revenue data for retail services and the cost data for retail services is likely to comply with the RAF. Other data involved in the imputation testing is not required to comply with the RAF.

2.8 Accuracy of the imputation RKR reports

The Ministerial Direction requires the ACCC to comment on the accuracy of the reports lodged by Telstra.

2.8.1 Audit process

The revised imputation RKR, as issued to Telstra on 29 September 2004, amended the audit required for the reports. The auditing period now reflects the financial year.

Clause 13 of the imputation RKR addresses the audit requirements for the reports. Telstra and the ACCC have agreed that the audit process be conducted in accordance with Australian Auditing Standard AUS 904 ‘Engagements to Perform Agreed Upon Procedures’.

Telstra engaged Ernst and Young to perform the audit process for the September 2003, December 2003, March 2004 and June 2004 quarterly reports. Ernst and Young’s report has been provided to the ACCC.

2.8.2 Accuracy of report

Given the audit carried out by Ernst & Young, the ACCC is satisfied that Telstra complied with the imputation RKR procedures as specified in the Regulatory Accounting Procedures Manual (RAPM) agreed between the ACCC and Telstra for the four quarterly reports pertaining to the 03–04 financial year.

Given that the September quarter results have not yet been audited, the ACCC cannot conclusively state whether the reports provided by Telstra for the September quarter 2004 comply in all respects with the imputation RKR.

The ACCC also notes that it has identified throughout this report particular factors which should be considered in assessing whether imputation test results prepared under the imputation RKR give an accurate indication of the margins actually available.