



Submission in response to ACCC  
Discussion Paper

**Fixed Line Services Final Access  
Determination – Primary prices**

PUBLIC VERSION

October 2014

# Contents

<b>Section 1. Executive Summary</b>	<b>4</b>
Promoting the LTIE in the next regulatory period	4
Impact of NBN on fixed line pricing	4
Compensation for declining demand	5
Allocating costs to promote LTIE	5
Setting access prices outside the FLSM framework	6
Recognising the impact of VoIP	6
Term of the FAD	6
<b>Section 2. General approach to setting access prices</b>	<b>7</b>
Setting prices that promote the LTIE	7
Consistency with the fixed principles	8
The implications of the NBN rollout	9
Length for the next FAD	10
<b>Section 3. Cost allocation</b>	<b>12</b>
Cost allocation under the current FLSM approach	12
Overarching observations on cost allocation under the fixed principles	13
Telstra's cost allocation proposal	14
<b>Section 4. Demand forecasts</b>	<b>17</b>
Current demand for fixed line services	17
Demand forecasts provided under the BBM RKR	18
Accounting for the uncertainty of NBN rollout	19
<b>Section 5. Telstra's expenditure forecasts in the BBM</b>	<b>21</b>
BBM RKR information provision	21
Capital Expenditure forecasts	21
Operating Expenditure forecasts	26
<b>Section 6. Determining prices and price structures</b>	<b>28</b>
Current approach to setting prices	28

Telstra’s proposed ‘flexible’ approach to setting prices	29
ULLS pricing	30
FOAS/FTAS pricing	31
Wholesale ADSL pricing	35
<b>Appendix A. Economic efficiency during transition to NBN</b>	<b>39</b>
Impact on the assessment of the long term interest of end-users	39
Elements of economic efficiency	41
Maximising efficiency in in absence of reinvestment	42
Relevance to the current FAD Inquiry	43

## Section 1. Executive Summary

- 1.1 Optus welcomes the opportunity to participate in the Australian Competition and Consumer Commission's (ACCC) consultation on the proposed final access determinations (FADs) for the declared fixed line services.

### Promoting the LTIE in the next regulatory period

- 1.2 The key element when setting terms of access that promote the long term interest of end-users (LTIE) is to promote efficiency in both a static and dynamic sense. Pricing that promotes competition (i.e. close to marginal cost) does this in a static sense, and also promotes competition in a dynamic sense. When dynamic considerations take into account the incentives to invest, and reinvest, especially with sunk assets, prices must be sufficient to ensure an adequate return to capital. This implies a price higher than marginal cost.
- 1.3 Promoting the LTIE has been a balancing act of these often conflicting objectives. In the current context of fixed line access pricing during migration to NBN, the trade-off between static and dynamic efficiency is less apparent. The efficient pricing of fixed line services during the current declaration period will need to take account of the switch-off of the copper customer access network (CAN) as it is gradually displaced by the NBN. Unlike some other jurisdictions, the switch-off of the legacy copper network is guaranteed under contractual and regulatory instruments.
- 1.4 This has important implication for the promotion of the LTIE for access to the CAN. In particular, less weight needs to be placed on the incentive for reinvestment as there will be no further investment in the CAN assets. However, unlike in some other jurisdictions (such as New Zealand), pricing of the legacy copper based services will not impede migration of services to the new fibre based technology being deployed by the NBN.
- 1.5 In this transition period, Optus submits that to the extent that the ACCC has discretion, then subject to ensuring that Telstra recoups its efficiently incurred direct costs, it should make decisions that would tend to lower access prices. Lower access prices are likely to improve competition in the fixed line market and lead to lower end-user prices in the transition to the NBN. There will be no damage to the incentive to invest as further investment is limited.

### Impact of NBN on fixed line pricing

- 1.6 A critical issue for the ACCC in setting access prices in the FAD is the impact of the NBN both in terms of its impact on competition and Telstra's costs of supply.
- 1.7 Optus notes that a number of the payments Telstra will receive from NBN Co relate to long-term arrangements that enable NBN Co to access and use existing Telstra infrastructure and assets, such as ducts and transmission capacity. Many of those assets are also used to provide retail and wholesale services and are relevant inputs to the ACCC's building block methodology. In addition, payments for the migration of Telstra customers can be seen either as a return of capital or as compensation for declining services on the legacy copper network. It is important for the NBN payments to be taken into account when setting access prices otherwise there is a very real risk that Telstra will be over compensated for the provision of fixed line services.

- 1.8 It is also legitimate for the ACCC to consider the broader competitive implications of the NBN payments. The NBN payments to Telstra will be substantial. They will significantly enhance the cash-flow and capital position of Telstra relative to its competitors. Such payments have a very real potential to distort the operation and development of an effective, competitive telecommunications market and undermine the anticipated benefits flowing from the NBN structural reforms. However, the negative impact on competition could be mitigated through the appropriate consideration of NBN co-payments within existing fixed line access price regulation.

### **Compensation for declining demand**

- 1.9 In the 2011 FAD the ACCC prices for the declared services were not adjusted to reflect declining demand. This reflected the ACCC's position that Telstra should not be compensated either for loss of market share resulting from competition or the fact that customers were choosing alternative products. There has been no change in the relevant legislation since the 2011 FAD which would justify the ACCC to alter its view on this issue.
- 1.10 Optus considers that the same rationale applies for the 2015 FAD. Demand for some fixed line services is expected to decline over the next five years, but it is clear that many of the drivers of that decline are within Telstra's control and it is largely protected from the impact of the decline for fixed line services. The key drivers of declining demand are:
- (a) Fixed to Mobile substitution. As the largest mobile provider Telstra is the beneficiary of fixed to mobile substitution. Since 2010, it has increased its market share by almost 10 percentage points;
  - (b) Migration of services to the NBN. The Definitive Agreement between Telstra and NBN Co provides substantial compensation to Telstra as services move off its legacy networks to the NBN;
  - (c) Increasing use of over the top services. These services rely on broadband access, and as the largest broadband provider Telstra is well placed to mitigate the impact.
- 1.11 Firms in competitive industries are not protected from the impact of declining demand in terms of their ability to recover costs. Regulated firms should not be treated as a special case.

### **Allocating costs to promote LTIE**

- 1.12 Telstra has put forward a set of alternate cost allocation factors from those used in the 2011 FAD. Unsurprisingly these seek to shift costs from Telstra retail services to the declared services. Optus has provided detailed commentary on the specific cost allocation factors, but in summary we have the following concerns:
- (a) The Telstra cost allocation factors reflect the impact of declining demand. As discussed above, this should not be allowed;
  - (b) The impact of that declining demand is disproportionately skewed towards wholesale access services on the unsubstantiated assumption that Telstra Retail services will decline faster than wholesale services; and
  - (c) The allocation factors unwind a number of specific decisions taken by the ACCC to better reflect its policy objectives (such as geographic cost differences in ULLS and WLR services).

- 1.13 Optus submits that Telstra's proposed cost allocation factors should not be adopted. The rationale for many of the changes are not valid and appear to amount to little more than an exercise in cost shifting from Retail to Wholesale services.
- 1.14 The current allocation approach adopted in the 2011 FAD enables Telstra to recover its costs. This method has had no negative impact on the profitability of Telstra's fixed line services. Telstra's EBITDA margin for fixed voice remains at 60% — the same level at the beginning of the 2011 FAD — and 44% for fixed data — increasing from 37%.<sup>1</sup> Optus further notes that the relative magnitude of regulated revenue is small compared to overall Telstra revenue. Telstra's complete fixed voice revenue comprised only 16% of total service revenue in FY14; and the regulated revenue component is even less at 6% of revenue.<sup>2</sup>
- 1.15 Optus considers that a continuation of the approach in the 2011 FAD would best promote the LTIE as it ensures regulatory certainty, as well as allowing Telstra to recover the efficient costs for the provision of declared services.

### **Setting access prices outside the FLSM framework**

- 1.16 Telstra has proposed an alternative approach to setting access prices which would provide the ACCC with the flexibility to set access prices at a point that is between the avoidable cost and the stand alone cost of providing that service. That is, prices could diverge (within bounds) from the outputs from the FLSM.
- 1.17 Optus does not support this approach. If applied it would break the causal link between prices and cost and is likely to create a significant risk of cost over or under recovery.

### **Recognising the impact of VoIP**

- 1.18 The fixed termination service applies to all suppliers of fixed calls and unlike access network services (like ULLS or WLR), it is not solely associated with Telstra's monopoly access network. As such, the FAD pricing for call termination needs to take into account the costs incurred by all providers of termination – most of which utilise IP technology and efficient soft switches. Moreover, with the deployment of NBN during the period of this FAD, pricing of termination must reflect the lower cost to provide IP termination to NBN-based end-users who utilise VoIP connections.
- 1.19 Benchmarking shows that the current fixed rate of 0.95cpm is over eight times the efficient cost to provide IP-based termination. Optus submits that the pricing of termination must decline to the efficient level during the period of this FAD. Failure to do so will remove incentives on Telstra, and other providers, to adopt efficient technologies to deliver the service.

### **Term of the FAD**

- 1.20 Optus considers that the term of the FAD should only apply for three year duration. This would be in line with the duration of the current Fixed Line Services Declaration.

---

<sup>1</sup> Telstra Full Year Results Announcement 2012, slide 9

<sup>2</sup> Telstra, 2013, Final Access Determinations Inquiry – Public response to information request under the BBM RKR, 25 November, p.6

## Section 2. General approach to setting access prices

- 2.1 This section summarises the general principles for setting access prices for fixed line services that should be addressed within this FAD inquiry. The section discusses:
- (a) Setting prices that promote the LTIE;
  - (b) Consistency with the fixed principles;
  - (c) The implications of the NBN roll out; and
  - (d) Length of the next FAD.

### Setting prices that promote the LTIE

- 2.2 The legislative criteria require that when making an access determination, the ACCC must take into account whether it will promote the LTIE among other issues.<sup>3</sup> When considering whether something promotes the LTIE, regard must be had to the following objectives:<sup>4</sup>
- (a) Promoting competition in relevant markets;
  - (b) Achieving any-to-any connectivity;
  - (c) Encouraging the efficient use of, and the economically efficient investment in, infrastructure by which services are supplied, including:
    - (i) the legitimate commercial interests of the access provider; and
    - (ii) incentives for investment.
- 2.3 Decisions made during this Inquiry need to balance the short term interest of end-users (promote competition, lower prices, increased usage) and the longer-term interests (ongoing access to services, reinvestment, new products and services, new networks). Short term interests, such as lower prices, are bounded by the requirement to cover the direct costs of providing access and the legitimate commercial interests of access providers. Longer term interests, such as adequate return to encourage investment, are bounded by concepts of efficient investment and long term competition by access seekers.
- 2.4 This is the first time under Part XIC where the ACCC is to consider the LTIE within the context of the transition from a legacy network to a wholesale only government funded national network. Optus believes that there is little guidance in the outcomes of previous decisions. To Optus' knowledge this is unprecedented worldwide; as such, the ACCC should be guided by the application of economic principles.
- 2.5 Appendix A outlines in detail how a focus on static efficiency best promotes the legislative criteria during the transition to NBN.
- 2.6 In summary, the incentives to further invest in the legacy copper network are increasingly diminishing. The LTIE will be best promoted if a greater weight is placed upon increasing static efficiency through a pricing regime that places more weight on promotion of

---

<sup>3</sup> Section 152BCA

<sup>4</sup> Section 152AB

competition than incentives to invest. That is, since there are no real incentives to further invest in the copper network, very little efficiency in a dynamic sense will be gained from maintaining the existing pricing regime which was designed to encourage infrastructure investment.

- 2.7 In the static sense, competition reduces the market power of producers (or a sole ‘producer’ of access infrastructure such as Telstra), which leads to lower prices and higher consumer surplus. Competition also disciplines producers in their use of resources thereby promoting efficient use of inputs and minimising waste. A price which reflects marginal cost maximises allocative and productive efficiency. Access pricing that reflects marginal cost is also likely to best promote competition in a dynamic sense – that is, both access seekers and access provider will face the same cost of access to legacy copper networks during transition to NBN. Both access seekers and access provider will be able to attract end-users on the same cost basis – and win or lose customers on the efficiency of their own operations. This will not only promote competition during transition to NBN, but better reflect the nature of competition post-migration, where all providers will have access to the same open access fibre network.

### Consistency with the fixed principles

- 2.8 The FADs set out fixed principles for the treatment of the RAB, including principles for estimating prices for the next regulatory period. The ACCC also acknowledged there should be alignment in these principles to *“ensure consistency in the application of the pricing methodology and minimise the risk of over- or under-recovery of costs by Telstra.”*<sup>5</sup>
- 2.9 Fixed principles provisions were established in the 2011 FAD to provide a framework for the ‘building blocks’ in the BBM approach. These provisions are intended to provide industry certainty over a longer term and will apply for a ten year period with a nominal termination date of 30 June 2021, and serve three main purposes:<sup>6</sup>
- (a) To establish the initial value of the RAB. The RAB roll forward mechanism was also determined as it would promote greater regulatory certainty.
  - (b) By specifying the ‘building blocks’ (and the key considerations to be taken into account when reviewing or updating forecasts), this will lock in the BBM framework for setting prices and provide certainty about the way the ACCC will estimate prices for future regulatory periods. Similarly, while the FAD does not specify values for any of the WACC parameters or tax rate to be applied, it provides some guidance on the relevant considerations or approach used to estimate these values.
  - (c) Considerations were also set out for the purpose of determining the cost allocation key to be applied. In particular, *“the cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.”*<sup>7</sup>
- 2.10 Optus notes that the fixed principles do not necessarily prescribe a value to the various ‘building blocks’ in the BBM. Consequently, the ACCC still has sufficient flexibility in accepting forecasts and allocation proposals for inclusion in the RAB in a manner that best promotes the LTIE. Where the ACCC has a choice between two alternate values or

---

<sup>5</sup> ACCC, 2013, Public inquiry to make a final access determination for the Wholesale ADSL service, Final Report, May, p.6

<sup>6</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, pp.130-132

<sup>7</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.132

approaches, it should adopt the approach which best promotes the LTIE – as discussed above and in Appendix A, this will be achieved by promoting competition and lower access prices as there will be limited further investment in the copper access network.

## The implications of the NBN rollout

- 2.11 Accounting for the impact of the NBN is a fundamental issue for this Inquiry, particularly given the level of payments to be received by Telstra: \$90 billion in nominal cash terms.<sup>8</sup> It has the very real risk of undermining the pro-competitive reforms trying to be achieved by the NBN project.
- 2.12 The need to address this issue in the current Inquiry should not be surprising. The ACCC has acknowledged that it will take into account NBN issues within the pricing of fixed line services since 2010.<sup>9</sup> This view was repeated in the Final Report for the 2011 FAD Inquiry.<sup>10</sup>
- 2.13 Additionally, the ACCC’s reasons for not including NBN payments during the last FAD are no longer valid. The rollout of NBN has commenced, Telstra has already received a payments totalling more than \$1 billion from NBN Co during the current FAD period. And in a number of fibre serving areas, Telstra’s copper network is due to be disconnected by the end of this calendar year.

Figure 1 NBN Co payments to Telstra (\$m)

	FY 2013	FY 2014
<b>TOTAL NBN Income</b>	<b>399</b>	<b>640</b>
<b>Commonwealth agreements &amp; other Govt policy commitments</b>	<b>303</b>	<b>259</b>
Retraining	11	14
Information Campaign and Migration Deed	168	87
TUSMA	124	157
<b>Infrastructure Services Agreement</b>	<b>89</b>	<b>316</b>
<b>PSAA</b>	<b>7</b>	<b>66</b>

Source: Telstra FY2014 results

- 2.14 It is therefore in the interest of competition and end-users that the treatment of NBN payments be revisited and factored into wholesale pricing arrangements.
- 2.15 There have been several submissions put before the ACCC outlining views on how to treat NBN payments. Optus does not intend to repeat the detailed reasons already put forward. Please refer to previous submissions prepared by interested parties, including the reports by NERA<sup>11</sup> and Frontier Economics<sup>12</sup> which put forward methods by which payments could be included in the FLSM.

<sup>8</sup> Korda Mentha, 2014, NBN Co Limited Corporate Governance Review, 8 August. Available at: [http://www.aph.gov.au/~media/02%20Parliamentary%20Business/22%20Chamber%20Documents/223%20Tabled%20Papers/Documents%20Presented/Out%20of%20session/080814\\_NBN\\_report.pdf](http://www.aph.gov.au/~media/02%20Parliamentary%20Business/22%20Chamber%20Documents/223%20Tabled%20Papers/Documents%20Presented/Out%20of%20session/080814_NBN_report.pdf)

<sup>9</sup> ACCC, Review of the 1997 telecommunications access pricing principles for fixed line services, Draft report, September 2010, p.29

<sup>10</sup> ACCC, Inquiry to make final access determinations for the declared fixed line services, Final Report, July 2011, p.29

<sup>11</sup> NERA, 2014, *Payments to Telstra for Lease/Purchase of Fixed-Line Assets; A Report for Optus*, March

<sup>12</sup> Frontier Economics, 2014, *Payments between NBN Co and Telstra and prices for the declared fixed line services; A report prepared for Herbert Geer*, March

2.16 The arrangement currently facilitating this transition is shaped by the Definitive Agreements (DAs) between Telstra and NBN Co, which was formalised in June 2011 – it provides for the migration of Telstra customers to NBN and for NBN Co to lease and acquire certain infrastructure from Telstra. However, these arrangements are currently being renegotiated in light of the proposed shift to a multi-technology model. The central role of Telstra in the delivery of the NBN will not change, and nor will the value of the Agreement. As noted in Telstra’s recent annual results announcement:

*We are committed to acting in the best interests of our shareholders, and **are focused on maintaining the value of the current agreements**, achieving certainty of outcome as soon as reasonably possible, and minimising any additional regulatory risk.<sup>13</sup> [emphasis added]*

2.17 It is clear that the arrangements between Telstra and NBN Co will fundamentally change the way Telstra’s fixed line assets are used. Given that this is the same investment for which NBN Co will compensate Telstra, there is a very real risk that Telstra will effectively be compensated twice for the same investment. Specifically:

- (a) Migration payments should be viewed as a ‘return of capital’ to Telstra shareholders for capital invested in the CAN. Accordingly, once received Telstra should no longer earn either a return on capital or a return of capital associated with the asset for which the payment was made.
- (b) Ducts, trenches and pits form part of the RAB for the CAN. Compensation for the use of RAB assets is a component of total compensation to Telstra, which represents a ‘return of capital’ to shareholders for capital invested in the network. Accordingly, the ACCC should deduct this RAB-related element of lease payments from Telstra’s RAB for fixed line services.<sup>14</sup>

2.18 Optus again wishes to highlight that the statutory role of the ACCC under Part XIC is to promote the long-term interests of end-users through increased competition and efficient use of, and investment in, infrastructure. The ACCC is legislatively required to consider what is best for all 23.5 million Australian end-users and not place undue weight on the interests of 1.4 million Telstra shareholders.

2.19 It appears that Telstra may also be arguing that the ACCC consider only the NBN-related inputs that favour its desired outcome (i.e. higher access prices). **[Telstra CiC]** Optus submits that it would appear unreasonable for the ACCC to take a position that allows consideration of NBN-related factors that would be favourable to Telstra but exclude from consideration factors that are not.

### **Length for the next FAD**

2.20 Optus considers that there are benefits to be gained from a shorter FAD. These include:

- (a) Prices will be more closely tied to costs actually incurred, as there would be more frequent reviews;
- (b) Costs to be more accurately forecast, especially in the context of dynamic industry changes; and

---

<sup>13</sup> Telstra, 2014, Full Year 2014 Financial Results – CEO/CFO Analyst Briefing Presentation, 14 August 2014

<sup>14</sup> Optus Submission in response to the ACCC’s discussion paper Public Inquiry to make Final Access Determinations for the Declared Fixed Line Services, June 2011, p.21

(c) The ACCC to gain more experience and expertise of Telstra's business through more frequent reviews.

2.21 Optus therefore considers that the regulatory period should be no more than three years, in order to ensure that prices are more closely tied to the costs incurred by Telstra.

## Section 3. Cost allocation

- 3.1 In this section, Optus will argue that given the uncertainty of the counterfactual, the ACCC's partial cost allocation approach should continue to be applied. We also note that there has been no legislative or market change that would justify the ACCC to change the view from the 2011 FAD that it is not appropriate to compensate Telstra for a loss of market share or reduction in the size of the market.<sup>15</sup> In a competitive market, an access provider would not be able to spread the costs of inefficient assets over remaining customers and remain competitive with more efficient suppliers. Further, the current approach already provides Telstra with a reasonable chance of recovering its costs.

### Cost allocation under the current FLSM approach

- 3.2 Allocation factors in the FLSM have been determined using a number of sources. The initial cost allocation factors in the FLSM used the Analysys model as a starting point; where the Analysys model factors were either not appropriate or available the ACCC used a number of alternative methodologies<sup>16</sup> to develop costs allocation for particular asset classes.
- 3.3 In summary,
- All of the methods adopted by the ACCC, including use of the Analysys model factors, **are based on relative usage of the assets included in the FLSM** to provide each of the declared fixed line services. Where costs cannot be directly attributed to assets, such as common assets like network buildings and indirect capital assets, the method adopted by the ACCC calculates an appropriate allocation to specific services using a proxy that broadly reflects expected usage of the relevant assets.<sup>17</sup> [emphasis added]*
- 3.4 Adjustments to reflect changes in the expected usage of assets to the declared fixed line services were also applied. These adjustments effectively hold fairly constant the share of costs allocated to each unit of service, and that changes in demand will therefore be reflected in the total costs allocated to the service.
- 3.5 Put simply, the partially allocated cost approach adopted in the 2011 FAD only responds to demand for declared services, not the demand for all fixed line services (including Telstra Retail). This should not be a problem given that the approach to cost allocations which are incremental to Telstra has been removed from the cost base so that an access seeker does not pay a share of any costs specific to Telstra Retail.
- 3.6 Importantly, *“only **a monopolist could recover inefficient costs from its remaining customers by charging prices that include monopoly profits.**”<sup>18</sup> [emphasis added]*
- 3.7 Optus considers that the partial allocation approach ensure Telstra is able to recover its costs. It is fair to say that the method adopted in the 2011 FAD has not had a negative impact on the profitability of Telstra's fixed line services.

---

<sup>15</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.98

<sup>16</sup> The alternative methods used to calculate cost allocation factors included: geographic cost basis; de-optimised Analysys model basis (PSTN only); and revenue share basis.

<sup>17</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.95

<sup>18</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.100

- 3.8 Furthermore, Optus considers that a continuation of this approach will best promote the LTIE as it will ensure regulatory certainty, as well as allow for Telstra to recover the efficient costs for the provision of declared services.

### **Overarching observations on cost allocation under the fixed principles**

- 3.9 Clause 6.14 in the Fixed Line FAD and WADSL FAD sets out the cost allocation factors that apply under the fixed principles provision. Namely, it highlights three key considerations:
- (a) The allocation of the costs of operating the PSTN should reflect the relative usage of the network by various services;
  - (b) Direct costs should be attributed to the services to which they relate. The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs; and
  - (c) No cost should be allocated more than once to any service.<sup>19</sup>
- 3.10 It follows that the determination of cost allocation factors should reflect the principles above except where reliable information is not available to support the application of the principles. The partial cost allocation approach already adheres to the principles above.
- 3.11 Optus makes a number of observations on cost allocation under the fixed principles that should continue to be applied.
- 3.12 First, the direct allocation of costs to the relevant service should remain the overarching principle. A direct cost approach will ensure that only the efficient costs can be recovered by the access provider from providing access to the relevant service.
- 3.13 Under the current approach, *“the cost allocation factors represent the share of costs incurred in supplying a particular service.”*<sup>20</sup> This is similarly one of the key legislative criteria that had to be addressed in the ACCC’s assessment of the BBM approach – i.e. under paragraph 152BCA(1)(d) of the CCA. In general, the ACCC acknowledges: *“The cost allocation factors are based on the directly attributable costs of providing specific services, as well as a share of non-attributable costs.”*<sup>21</sup>
- 3.14 Second, where direct cost allocation is not feasible, the allocation approach should take into account relative usage of the network asset according to an appropriate metric, such as network traffic. An example of this could include converting network usage according to a single metric, such as Mbps, then determining the relative usage based on that metric. In this case, number of SIOs is not appropriate as it is unable to distinguish between the different profiles of SIOs and/or their usage across the different services.
- 3.15 Under the current approach, the ACCC similarly notes that while *“The share of attributable costs allocated to a particular service is based on usage of the assets used to provide the service. For costs that cannot be attributed to particular services, such as corporate*

---

<sup>19</sup> ACCC, FAD Instruments for the declared fixed line services, 20 July 2011; and ACCC, FAD Instrument for the Wholesale ADSL Service, 29 May 2013

<sup>20</sup> ACCC, 2011, Public inquiry to make final access determinations for the declared fixed line services, Discussion Paper, April, p.123

<sup>21</sup> ACCC, 2011, Public inquiry to make final access determinations for the declared fixed line services, Discussion Paper, April, p.135

*overheads, the cost allocation factors allocate a share of these indirect costs to services based on allocation rules broadly related to each service's usage of network assets.*"<sup>22</sup>

- 3.16 The ACCC's approach best addresses the legislative criteria during the transition to the NBN. Moreover, it is an effective approach to help manage the risks of incorrect forecasts, especially when there are significant demand uncertainties around the transition to NBN.
- 3.17 Optus considers there would appear little support for the view that the partial allocation is inconsistent with the fixed principles.

### **Telstra's cost allocation proposal**

- 3.18 Telstra has proposed a new fully allocated cost model to determine the cost allocation key to be applied in the FLSM. This is primarily driven by the demand forecasts provided by Telstra and to compensate for any loss of market share or overprovisioned assets, it is intended that *"under the proposed fully allocated model, a share of the impacts of declining demand will be borne by access seekers through higher access prices."*<sup>23</sup>
- 3.19 In doing so, Telstra's proposal will effectively unwind the ACCC's decision in the 2011 FAD that *"it was not appropriate to compensate Telstra for a loss of market share or for reductions in the size of the market."*<sup>24</sup> Examples of this can be seen through Telstra's proposed treatment for:
- (a) Removal of the adjustment for geographic cost differentials in supplying ULLS and WLR previously applied to 'ducts and pipes' and 'copper cables'; and
  - (b) Change in the cost allocation factors applicable to PSTN switching equipment. This is likely to be a result of combination of factors including the removal of the de-optimised adjustment from the Analysys model, decline in forecast PSTN OTA traffic and reduction in the assumption of LCS minutes, amongst other things.
- 3.20 Additionally, Telstra is already being compensated for loss of customers through NBN payments. It does not appear reasonable to use the same reason to justify higher access prices. Optus observes Telstra's own comment that it's *"PSAA income has increased in line with NBN Co's rollout."*<sup>25</sup> In many respects the migration payments represent a top-up of Telstra's margins to reflect the impact from the NBN. That is, they keep Telstra 'whole'.

### **Telstra's proposed cost allocation factors to be applied to the FLSM**

- 3.21 Telstra's proposed cost allocation framework (CAF) model attempts to address its claim that *"the current cost allocation approach in the FLSM is unnecessarily complex, does not provide certain with respect to cost recovery, and is internally inconsistent"*<sup>26</sup> by introducing a standalone CAF Model for the purposes of determining the relevant cost allocation factors.

---

<sup>22</sup> ACCC, 2011, Public inquiry to make final access determinations for the declared fixed line services, Discussion Paper, April, p.142

<sup>23</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – primary price terms, Discussion Paper, July, p.x

<sup>24</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.98

<sup>25</sup> Telstra, Full Year 2014 Financial Results, CEO/CFO Analyst Briefing Presentation, 14 August 2014, p.18

<sup>26</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – primary price terms, Discussion Paper, July, p.40

- 3.22 However, while Telstra’s CAF Model may be internally consistent (insofar that the relevant allocators for the declared fixed line services are determined within the same framework), it is unnecessarily complex given the number of assumptions and adjustments have been considered in the CAF Model. In order to establish cost causal relationships between declared services and the shared fixed line networks, Telstra must also introduce a suite of additional drivers (in addition to routing factors, MOUs, SIOs and geographic bands) so that a full allocation of the fixed costs to all services using the fixed network asset can be achieved. Notably, not all FLSM Asset Classes in the CAF Model use the same allocation process to calculate the cost allocation factors that will subsequently be applied in updating the FLSM.
- 3.23 The CAF Model appears to be just as unnecessarily complex, if not more so, than the current cost allocation it is supposed to replace. Optus does not consider it is reasonable to suggest replacing the current approach because it is unnecessarily complex by another method which is just as complicated.
- 3.24 In addition, Optus notes that while the CAF Model currently reports the aggregate allocation factors for Other Fixed Line and Other Services separately, it is interesting to note that for the vast majority of the applicable FLSM Asset Classes for Other Services. **[Telstra CiC]** This is despite Telstra’s acknowledgement that:

*‘Other non-fixed line’ includes use by Telstra’s HFC network, transmission cables, NBN Co’s cables (installed in Telstra’s ducts under the agreements between Telstra and NBN Co) and cables of other third party infrastructure providers.<sup>27</sup>*

#### Fully allocated cost versus partially allocated cost approach

- 3.25 The fundamental difference between the current approach and Telstra’s proposal is that the unit cost of regulated services increases under the Telstra approach. Under the current approach, the allocation factors are adjusted to ensure that the *unit cost* of regulated services will remain constant in the presence of falling demand. This does not prevent the unit cost from changing as the level of costs change; it only prevents changes in demand, due to increased competition or decreases in the size of the market, from impacting the unit cost.<sup>28</sup>
- 3.26 Telstra considers that the ACCC’s cost allocation approach currently does not allocate costs on a fully allocated cost approach; insofar as it does not attempt to directly attribute any of the RAB costs to non-regulated services in the FLSM.
- 3.27 Optus notes that Telstra has also altered some of the FLSM asset classes, and subsequently its treatment for cost allocation purposes. For example, Figure 2 provides a comparison of the allocation keys considered for determining the relevant allocation of asset classes to each of the declared services. Notwithstanding the changes in the cost allocation values applied to all services and asset classes, this highlights that changes to the treatment of WLR and WADSL have also been applied.

Figure 2 Comparison of the allocation of Assets Classes to services (FLSM vs Telstra CAF)

**[Telstra CiC]**

Source: ACCC; FLSM v1.2 for WADSL draft FAD; Telstra CAF Model v1

<sup>27</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – Additional information on cost allocation, July 2014, p.7

<sup>28</sup> ACCC, 2011, Public inquiry to make final access determination for the declared fixed line services, Discussion paper, pp.127-8

- 3.28 There is no doubt that this issue will need to be reviewed again when Telstra provides its revisions to the inputs to this framework. Irrespective, the output from the CAF if accepted should not result in allocation factors that significantly deviate from that used in the FLSM.

*There should be no change to the current cost allocation approach in the FAD*

- 3.29 Optus is therefore concerned that Telstra's proposal will simply lead to higher access prices, which are not in the LTIE. Importantly, there appears to be no evidence to warrant the ACCC changing its 2011 views on this issue.
- 3.30 As noted above, the ACCC assessed a proposal put forward by Telstra based on a fully allocated method during the last FAD inquiry. The 2011 FAD Final Decision was emphatic in its rejection of Telstra's proposal. The Final Decision did not accept Telstra's view that the allocation factors should reflect the declining total demand for fixed line services. It stated:
- (a) Telstra's proposal would mean the cost of the network is recovered from a smaller subscriber base;
  - (b) Lead to higher access prices for remaining services; and
  - (c) Telstra is compensated for these business risks through adjustments to the WACC.
- 3.31 The ACCC should apply the same logic to reject Telstra's latest proposal on cost allocations.

## Section 4. Demand forecasts

- 4.1 This section discusses the various treatments for demand forecasts being proposed within the context of this FAD inquiry.
- (a) Current demand based on market information;
  - (b) Review of Telstra's BBM forecast demand;
  - (c) Accounting for the uncertainty of NBN forecasts.
- 4.2 The demand forecasts are in the process of being updated by Telstra. This submission, therefore, does not provide detailed comments on the figures proposed by Telstra. Rather, we focus on the underlying issues and assumptions. Optus looks forward to providing more detailed comments on the actual forecast to be used once it is submitted by Telstra.
- 4.3 Efficient demand forecasts are key if this FAD is to promote the LTIE. These demand assumptions contribute towards the overall size of the CAN, as well as the pool of services through which the FLSM is able to recover the cost to service. Optus repeats and supports the view that *"it was not appropriate to compensate Telstra for the loss of market share or for reductions in the size of the market."*<sup>29</sup>
- 4.4 Similar to the issues raised in Section 3, the demand forecasts and the cost allocation approach are intrinsically linked. This means that under the partially allocated cost approach, it was transparent to the extent that cost allocation factors would change in line with the changes in demand. Under the existing partial allocation approach, errors in forecasting demand have less of an impact.<sup>30</sup> This is a further advantage to the partial allocation approach which must be recognised.

### Current demand for fixed line services

- 4.5 In general, there is a common view that demand for fixed line services will decline during the next regulatory period. The extent of this declining demand, however, remains more contentious. Demand information also varies depending on the sources relied on.
- 4.6 This was recognised in the 2011 FAD.<sup>31</sup> The same observation continues to hold true today. For example, while there has been a slowing in the declining demand for PSTN lines (for fixed voice) in recent years, Telstra's annual fixed line SIOs demand profile for its fixed voice base is not in line with its fixed broadband base, which has on average increased by 2% YoY over the period FY09 to FY14.<sup>32</sup> This is shown in Figure 3 below (when excluding the yellow bars).

---

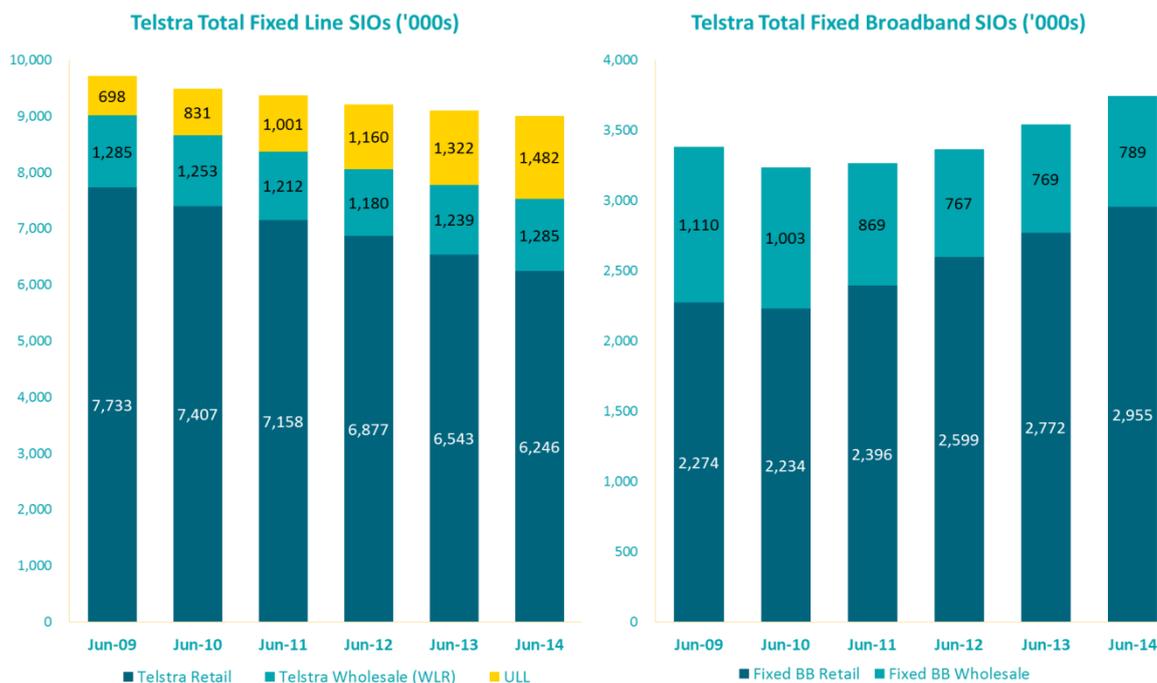
<sup>29</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.98

<sup>30</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.128

<sup>31</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.84

<sup>32</sup> This is despite a -4% decline in demand between FY09 and FY10. In all subsequent years, the YoY change has been steadily increasing

Figure 3 Telstra fixed voice (including ULLS) and fixed broadband SIOs



Source: Telstra Annual Report 2014

- 4.7 Telstra does not include ULL SIOs within its total count of fixed line SIOs (basic access lines) despite the ULLS being an eligible (and declared) service that is provided over Telstra’s CAN. However, Figure 3 also highlights that when access seeker ULL SIOs are taken into account, the decline in demand for total services supplied by the CAN is only on average a -1% YoY change<sup>33</sup> over the period from FY09 to FY14 in the total size of the CAN.
- 4.8 This approach again differs in Telstra’s proposed cost allocation framework which acknowledges that for a number of Asset Classes, the costs are assumed to be driven by the number of fixed line SIOs. More specifically, the combined SIO forecast for *all* services (ULLS, WLR, PSTN retail access, ISDN access and other DSL access).<sup>34</sup>
- 4.9 Similarly, ISDN access and other DSL access SIOs are not consistently included within the current reporting frameworks. For example, ISDN access is not included within the count of total ‘Basic Access’ lines in Telstra’s annual reports, but is instead reported as a separate ISDN access (reported in terms of Basic Access line equivalents).

### Demand forecasts provided under the BBM RKR

- 4.10 Telstra has provided its forecast demand for the regulatory period in Table C4 of its response to information request under the BBM RKR. These BBM forecasts (for the specified fixed line services) have also been aligned with the demand forecasts (including the relevant other Telstra Fixed Line) considered within the Telstra CAF Model. Figure 4 summarises the service type that are captured within the demand forecasts provided by Telstra.

<sup>33</sup> This is compared to a -4% YoY change over the same period when the ULL SIOs are not taken into account.

<sup>34</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – Additional information on cost allocation, July 2014

Figure 4 Telstra demand forecast – service types

[Telstra CiC]

Source: Telstra BBM RKR response, Telstra CAF Model v1

- 4.11 As highlighted above, there are numerous reporting metrics that can be used to report actual and forecast demand for fixed line services. Another reporting framework that is often referred to in the context of fixed line services is reference to the ACCC's CAN RKR.<sup>35</sup>
- 4.12 Telstra's forecasts consider [Telstra CiC]
- 4.13 The BBM demand forecasts and the demand forecasts provided in the Telstra CAF are largely aligned except for some key exceptions. For example, despite being provided as part of the BBM RKR, the CAF model does not take into account the disaggregated nature of the wholesale ADSL forecasts or the peak usage estimates for ADSL. These are likely to contribute to significant drivers of cost and relative usage.

#### Accounting for the uncertainty of NBN rollout

- 4.14 The current FLSM does not take into account any impacts of the NBN rollout. Therefore, updating the FLSM will involve taking the NBN rollout taken into account – whether it is through the form of disposal and leasing of assets in the RAB to NBN Co; impacts on forecasts from NBN rollout; and/or factoring NBN demand into allocation factors.
- 4.15 It follows that accepting declining demand forecasts in line with forecast NBN rollout, with no recognition of the corresponding NBN payments (either whole or in part) will inevitably result in the FLSM setting access prices for declared services above efficient costs. This would not promote the LTIE. This means an important issue in the area of demand forecasting relates to NBN migration. Therefore, the approach taken by Telstra is currently flawed.
- 4.16 Optus submits that access prices should not increase as a result of migrations to the NBN reducing the demand for services on Telstra's CAN. If this position were different, and access prices were increased, then Telstra would be compensated twice for each customer migration, once by NBN Co through its migration payments and a second time by its remaining customers on the CAN through higher access prices. This would inevitably allow Telstra to over-recover its costs and damage competition during and after the transition to NBN. It would provide Telstra with a significant first-mover advantage to the NBN. Further, as shown in Appendix A, such an outcome would not be consistent with the legislative criteria.

#### Telstra's NBN assumptions and its impact on demand forecasts

- 4.17 Telstra's proposed forecasting methodology for demand is two-fold. In general, changes in demand are forecasted at a product level by individual product managers. This is then adjusted down by a separate demand forecast based on Telstra's internal NBN assumptions which is calculated separately.
- 4.18 Telstra's NBN assumptions are set out in Attachment 1 of its November 2013 response to the information request under the BBM RKR. These assumptions remain as at June 2013, and as such, "*subsequent amendments to the planned roll-out schedule and the potential*

<sup>35</sup> Refer to Quarterly snapshots of ULLS, LSS and DSL, available from ACCC website:

<http://www.accc.gov.au/regulated-infrastructure/communications/monitoring-reporting/telecommunications-reports-record-keeping-rules/quarterly-snapshots-of-ulls-lss-and-dsl>

*impact of the September 2013 Federal Election have not been taken into account.*<sup>36</sup> The impact of these NBN assumptions on the annual cumulative forecast volumes used for individual demand forecasts by respective product managers are summarised in Figure 5.

Figure 5 Telstra NBN assumptions

---

**[Telstra CiC]**

---

Source: Telstra BBM RKR response

- 4.19 Optus notes that these forecasts and assumptions will likely change, so will need to be reconsidered in the short term. Regardless, there is significant concern as to the allocation of declining demand for Wholesale services compared to the declines forecast for Retail services.

---

<sup>36</sup> Telstra, 2013, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, 25 November, p.59

## Section 5. Telstra's expenditure forecasts in the BBM

- 5.1 The move from TSLRIC to a BBM approach was specifically intended to address the decoupling of prices from actual costs. However, because the introduction of a BBM will link revenues to costs, there are concerns that simply accepting Telstra's forecasts without robust analysis might bring about a weakening of Telstra's incentives to minimise costs.
- 5.2 In this section, Optus provides comment on the expenditure forecasts that Telstra has provided in response to the BBM RKR – which has subsequently been acknowledged will be revised before the release of the FLSM as part of this FAD Inquiry. This submission, therefore, does not provide detailed comments on the figures proposed by Telstra. Rather, we focus on the underlying issues and assumptions. Optus looks forward to providing more detailed comments on the actual forecast to be used once it is submitted by Telstra.

### BBM RKR information provision

- 5.3 Optus considers that should a common approach for costs be adopted, then the same should be considered for the common revenues accrued through NBN payments. Failing to acknowledge the implications (even in part) of NBN payments will allow for recovery of costs above the efficient costs of supplying the fixed line services.
- 5.4 Consideration should be taken in terms of the impact of NBN, and its implications in relation to expenditure forecasts. For example, Telstra has acknowledged that its expenditure on the PSTN is driven by the need to maintain a quality of service during the transition to NBN and for USO purposes. As such, Optus notes that Telstra may already be compensated for these costs through non-FAD revenue – e.g. NBN payments cover the value/cost of end-user migration and TUSMA payments more than cover the cost of the CSG/USO.
- 5.5 The approach adopted in the BBM RKR currently does not appear to adhere to cost causation principles. While Telstra has adopted a 'bottom up' approach to preparing its BBM RKR forecasts, the forecasted costs have been made based on assumptions as at 30 June 2013 and are not necessarily aligned to specific services but the FLSM Asset Classes more generally. The ACCC notes that:

*... the level of detail on Telstra's forecasting methodology provided in Telstra's BBM RKR response does not allow the ACCC to fully identify the effect on the forecasts of Telstra's assumptions and the effect of using alternative assumptions.<sup>37</sup>*

- 5.6 Telstra has acknowledged that the forecast values will change and that the forecasting framework put forward is subject to internal review, but will likely remain. Optus therefore defers further comment on this issue pending the release of the revised information.

### Capital Expenditure forecasts

- 5.7 The RAB roll-forward mechanism established during the last FAD inquiry inferred that the RAB closing value at 30 June 2014 would be the opening RAB for the next regulatory period. In addition, the ACCC effectively stated there would be no ex post adjustment of costs for

---

<sup>37</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – primary price terms, Discussion Paper, July, p.34

capital expenditure.<sup>38</sup> The ACCC had previously acknowledged that any capital works required in relation to the DAs would be met from within Telstra’s existing capital expenditure target.<sup>39</sup> Optus considers that forecast capital expenditure in any future regulatory period should similarly be met within existing capex targets. As discussed elsewhere in this submission, Telstra is already receiving payments from NBN Co that will more than account for any capital works required in relation to the NBN Agreements.

5.8 Figure 6 below sets out Telstra’s publicly reported accrued capital expenditure.

Figure 6 Telstra accrued capital expenditure

	(\$m)	FY09	FY10	FY11	FY12	FY13*	FY14
<b>Accrued capital expenditure</b>		4,598	3,471	3,410	3,591	3,689	3,661
<i>Note: Accrued capex is defined as additions to property, equipment and intangible assets, including capital lease additions, measured on an accrued basis.</i>							
<i>For FY13, this is restated value from the \$3,792m noted in the Telstra Annual Report 2013</i>							

Source: Telstra Annual Report 2014

5.9 The reported capex includes a wider range of capex projects (e.g. mobile) undertaken by Telstra Group. However, it can still provide guidance on the level of capex forecasts that may apply during the next regulatory period. This in turn should be supported by a number of other fixed line related capex announcements made by Telstra.

5.10 For example, during its 2013 Investor Day presentations, Telstra announced a refined long term strategy across the critical areas of customer service, core revenue and growth. In particular, it announced plans to ‘drive value from the core’ across a number of areas including fixed broadband.<sup>40</sup> This was in line with its 2013 annual report which acknowledged the recent completion of *“an upgrade of over 1,800 sites providing ADSL 2+ broadband coverage to another 400,000 premises.”*<sup>41</sup>

5.11 The ACCC in 2011 effectively accepted Telstra’s allocation of forecast capital expenditure to asset classes as reasonable. While this remains an area of discretion that is difficult for access seekers to comment on, the allocation applied in the 2011 FAD should provide a guide on the likely allocation of forecast capex to be expected in subsequent years.

### Telstra’s forecasting methodology for capital expenditure

5.12 Telstra’s new methodology for forecasts in the next regulatory period represents a departure from the FLSM approach to forecasting capex based on a projected percentage growth applied to historic capital expenditure at the asset class level in the base year of the RAB. It is now proposed to be based on a ‘bottom-up’ approach where *“Telstra’s new method is to identify the projects related to the FLSM asset classes and then, based on the project program, to identify spend in future years for these projects.”*<sup>42</sup>

<sup>38</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.53

<sup>39</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.55

<sup>40</sup> Telstra, 2013, Investor Day – Media Release and Slide Presentations, 23 October 2013

<sup>41</sup> Telstra, 2013, Telstra Annual Report 2013, p.6

<sup>42</sup> Telstra, 2014, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, Comparison Statement, February, p.20

- 5.13 However, Telstra’s forecasting methodology appears loaded with forecast capex for projects that are predominantly related to Telstra Retail driven activities. Based on the forecasts and supporting reports provided, it remains unclear how the distribution effects will flow to access pricing for the suite of declared services in the FLSM.
- 5.14 For example, there are currently a number of anomalies or pure coincidences that can be observed from the capex forecasts to FY19:
- (a) The forecasts provided have been allocated according to the FLSM asset classes; however it remains unclear to what extent this allocation takes into account the objectives of the capital expenditure being incurred.<sup>43</sup> While a bottom up approach has been applied to determine the relevant asset class, there is no correcting allocation to ensure that only the cost causation principles are applied. This implies that there is potential that costs may be allocated to services which do not benefit from the capital expenditure being incurred (e.g. there is a risk that costs will be allocated unfairly to a service even if it has not relation to the capital project being undertaken, hence failing the fixed principle for direct cost allocation).
  - (b) From an individual FLSM asset class perspective, there is a considerable spike in the capex forecasts for several asset classes in FY15, despite industry expectations that further investment is unlikely to occur given that NBN will over time lead to copper shutdown. During this period, Telstra is also expected to receive NBN payments for both the leasing and transfer of assets in the last mile to NBN Co. Failing to take these payments into account will result in double recovery in two forms: first through the NBN payments (bundled or otherwise) and second, through the access charges for declared services from access seekers.
  - (c) The prudence and efficiency criteria have been described by Telstra, such that as a consequence of some key distinctions within the broader context of its investment decisions: *“There is no incentive for Telstra to ‘gold-plate’ fixed line services infrastructure in circumstances where greater returns could readily be obtained by investing scarce capital in other growth areas of the business.”*<sup>44</sup>
  - (d) The impact of NBN rollout on Telstra’s forecasts appears inconsistent. On one hand, it assumes NBN rollout is imminent and relies largely on the NBN Corporate Plan information as at 30 June 2013, thereby adopting an approach which has explicitly factored into the demand forecasts the assumed loss in fixed line SIOs due to the NBN rollout. On the other, this same approach is not applied with respect to capital expenditure (and similarly, operating expenditure) forecasts – which does not appear to factor in the assumed loss in fixed line SIOs.
- 5.15 In addition, the forecasts provided by Telstra have been provided from real 2013 dollars using its own forecasts of CPI. This means that it will need to be adjusted before it can be used to update the FLSM.

### Concerns with Telstra’s BBM forecasts

- 5.16 Telstra has provided its forecast capex for the regulatory period in Table C2 of its response to information request under the BBM RKR. While these capex forecasts are, in aggregate,

---

<sup>43</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – primary price terms, Discussion Paper, July, p.34

<sup>44</sup> Telstra, 2013, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, 25 November, p.6

less than the capex forecasts previously applied in the FLSM, Optus is concerned with the breakdown of the forecasts applied to the individual FLSM Asset Classes.

- 5.17 In particular, Optus' concerns with respect to the expenditure forecasts and allocation of these forecasts to asset classes are further discussed below.

### *Prudency of Telstra's forecasts*

- 5.18 The prudency of Telstra's expenditure forecasts has not been justified. The supporting documentation to its BBM RKR response does not address the prudency criteria. Rather, the reasons provided by Telstra to justify its prudency of investment (in a general sense) merely highlight that these are also subject to the same criteria as investments in the other unregulated parts of the Telstra business. This by itself is not evidence of prudency.
- 5.19 In particular, Telstra assesses the capital investment project on its merits, and internal rate of return (IRR) potential, rather than just its ability to be recovered through regulated revenue streams.
- (a) First, the approval process requires that any capital investment project must make a return: *"Within Telstra, capital investment projects for fixed line network assets and services will only be approved if they are expected to meet specified internal rate of return targets."*<sup>45</sup> This suggests that within their own right, the capital investments should already meet the requisite IRR targets for the provision of fixed line services (regulated and unregulated).
- (b) Second, while there may be internal competition for capital allocation between the regulated and unregulated fixed line services, this is still occurring despite Telstra's own acknowledgement that: *"the declared fixed line services account for only approximately 6% of Telstra's total revenue (all fixed line voice and fixed broadband revenue accounts for approximately 25% of Telstra's total revenue)."*<sup>46</sup> As such, remains well within the general Telstra outlook that *"capital expenditure to be around 14 per cent of sales."*<sup>47</sup>
- (c) Third, Telstra also notes that this investment is required to allow it to compete in the fixed line sector: *"Telstra also utilises its fixed line network to deliver downstream retail services to compete not only with access seekers using Telstra's fixed line network, but also with competitors using alternative infrastructure."*<sup>48</sup>
- 5.20 These, however, do not justify the expenditure forecasts provided in its BBM response. The relevant question for this Inquiry is whether the level of expenditure proposed on a copper network that is being shut down is efficient. We note that while expenditure that is incurred to meet CSG/USO or NBN obligations is likely to be included, such expenditure *must not* be allocated to fixed-line service as there is no causal relationship, as per the FAD fixed principle requirements.

---

<sup>45</sup> Telstra, 2013, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, 25 November, p.6

<sup>46</sup> Telstra, 2013, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, 25 November, p.6

<sup>47</sup> Telstra, "Telstra delivers revenue, profit and customer growth; increases dividend; announces share buy-back and positions for future growth", Media Release, 14 August 2014

<sup>48</sup> Telstra, 2013, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, 25 November, p.6

## Allocation of forecasts to FLSM asset classes

- 5.21 Telstra's approach to allocation of the forecasts to individual asset classes is based only on its causal relationship between the forecast expenditure and the asset class. However, even though this has been determined on a bottom up basis at the project level for an individual service or set of services, the same attention to detail has not been taken to ensure that the expenditure (i.e. direct costs) is recovered from only the relevant service. This is contrary to the underlying principle of direct cost allocation.
- 5.22 For example, [Telstra CiC]. This is despite the general view that it is common practice for a firm to minimise expenditure on a soon to be retired asset ('sweat the asset') in order to maximise its return. This is consistent with public statements made by Telstra in relation to declining expenditure on its copper network.<sup>49</sup>
- 5.23 The fixed principles require that costs first get allocated to services on a direct cost causation basis; and only where such an approach is not possible should costs be allocated using an indirect method. Optus has concerns that the cost allocation proposal provided by Telstra unnecessarily avoids the use of direct allocations. For example, it has been noted:
- (a) For the 2011 FLSM, Telstra supplied to the ACCC information on its capital expenditure and asset register by asset categories which were more disaggregated than the asset classes used in the FLSM. The ACCC then reconciled this information to reflect the relevant FLSM asset classes.<sup>50</sup> This was updated in 2013 to account for the inclusion of WADSL direct assets. Since then, there has been no significant event that should trigger and warrant any re-categorisation of the FLSM asset classes – however, Telstra's proposed CAF currently shows there is a shift in the relevant asset class applicable for allocation purposes for both WLR and WADSL.
  - (b) Telstra has utilised IMC level data in preparing its forecasts, which can be broken down into a number of expenditure drivers. [Telstra CiC]. Telstra similarly acknowledges that "... there is significant variation in the relative importance of each included IMC to the forecast values."<sup>51</sup> For example, based on the top 10 IMC programs that has been provided it is clear that the distribution of estimated IMC-level spend is not uniform across the various FLSM asset classes.<sup>52</sup> However, despite the level of preparation used breakdown capex by investment programs, this does not explain why the variations are by IMC code and/or asset classes cannot be taken into account for the purposes of direct allocation.
- 5.24 A further high-level analysis of the information that has been provided on the top 10 IMC programs highlights the potential for the information to be further applied to determine the cost causation relationship between the IMC descriptions, the FLSM asset classes, and identification of the relevant services for direct cost allocation.
- 5.25 For example, based on the top 10 IMC investment programs identified, [Telstra CiC].

---

<sup>49</sup> In 2010, Telstra CFO John Stanhope stated that "we have factored in some lower CAPEX on the CAN, but as you probably know, we're not spending a lot of money on the copper network now." Telstra, 2010, NBN conference call transcript, 21 June 2010

<sup>50</sup> Telstra, 2014, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, Comparison Statement, 7 February, pp.8-10

<sup>51</sup> Telstra, 2014, Final Access Determinations (FADs) Inquiry – additional information in response to information request under BBM RKR, February, p.20

<sup>52</sup> Telstra, 2014, Final Access Determinations (FADs) Inquiry – additional information in response to information request under BBM RKR, February, p.21

- 5.26 It is clear from Telstra’s discussion that the majority of expenditure is demand driven, and that the demand is coming from growth in DSL products. This implies that it is very possible that very few of the CAN costs identified should be allocated to the ULLS product. Optus repeats that as per the fixed principle requirements, costs must first be directly allocated to services. Only where this is not possible should allocation be done via indirect methods.

### Operating Expenditure forecasts

- 5.27 The FLSM adopted a ‘top down’ approach to determining opex allocations during the 2011 FAD. That is, opex was first allocated to CAN and Core networks then apportioned “to each asset class according to its share of the total undepreciated asset value in 2008-09.”<sup>53</sup>

#### Telstra’s forecasting methodology for operating expenditure

- 5.28 Similar to the approach proposed for capital expenditure forecasts, Telstra has adopted a ‘bottom up’ approach to determine its operating expenditure forecasts.
- 5.29 Telstra has acknowledged that its opex forecasts are comprised of four key elements:<sup>54</sup>
- (a) Estimated opex that is directly and indirectly attributable to the relevant FLSM asset classes and relevant fixed line services as incurred by the Telstra Operations Business Unit, excluding opex relating to capital projects;
  - (b) Estimated direct and indirect opex related to capital projects based on analysis of RKR capex forecasts, as attributable to the FLSM asset classes;
  - (c) Estimated opex attributable to the regulated fixed line services as incurred by the Telstra Wholesale Business Unit; and
  - (d) An estimated mark-up to reflect a contribution towards unattributable costs (e.g. a contribution towards corporate overheads).
- 5.30 Of the above four components, the majority of relevant opex is forecast to be incurred by Telstra Operations Business Unit – **[Telstra CiC]**. It should also be noted that each of these components has been forecasted using different approaches. In addition, similar concerns identified in the discussion for capital expenditure exist.
- 5.31 For example, there are currently a number of anomalies or pure coincidences that can be observed from the capex forecasts to FY19:
- (a) It can be argued that if the demands for PSTN services are declining, Telstra’s opex is also likely to decline. As volume and customer numbers fall, faults and call-outs are likely to occur less frequently than if the assets were fully utilised. However this does not seem to be the case based on the forecasts provided. Rather, the forecasts appear to show that even with declining demand, the aggregate opex costs (e.g. for faults) are still growing. This means that over time, the relative costs of addressing a fault becomes relatively more expensive to resolve on a per SIO basis.
  - (b) From an individual FLSM asset class perspective, with the exception of forecasts for the period FY15 for all asset classes, the opex forecasts for subsequent years have

---

<sup>53</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.80

<sup>54</sup> Telstra, 2013, Final Access Determinations Inquiry – confidential response to information request under the BBM RKR, 25 November, section 5

increased in line with Telstra's forecast inflation across almost all asset classes (with some notable exceptions). A similar approach was taken in the forecast of indirect operating expenditure; however this has not been separately allocated to individual asset classes by Telstra.

- (c) Opex forecasts have now also been provided separately for CAN indirect capital assets and CORE indirect capital assets. This was previously not provided in the FLSM, which included these estimates within the indirect operating expenditure calculated using the 80% uplift of allowed direct opex in the FLSM.<sup>55</sup>
- (d) The information on the top 10 IMC programs, which contribute **[Telstra CiC]** to aggregate propex<sup>56</sup> relevant to the FLSM Asset Classes for the forecast period, in the BBM RKR highlight that the significant proportion of the forecast opex is driven by **[Telstra CiC]**.<sup>57</sup> While some of these IMC codes differ from that identified for the top 10 IMC codes for capital expenditure, similar observations can still be made as discussed above.

- 5.32 Based on the forecasts and supporting reports provided, it remains unclear how the distribution effects will flow to access pricing for the suite of declared services in the FLSM.
- 5.33 Telstra has provided its forecast opex for the regulatory period in Table C1 of its response to information request under the BBM RKR. Optus' concerns with respect to the expenditure forecasts and allocation of these forecasts to asset classes are further discussed below.

#### Reasonableness of Telstra's forecasts

- 5.34 The reasonableness of Telstra's expenditure forecasts is currently cited as being driven by three major factors: **[Telstra CiC]**. Their relative importance (and magnitude) in the context of fixed line services are further magnified when viewed in combination (i.e. there is an inherent correlation between the interactions of assumptions underlying these three factors).
- 5.35 **[Telstra CiC]**
- 5.36 **[Telstra CiC]**
- 5.37 **[Telstra CiC]**
- 5.38 **[Telstra CiC]**
- 5.39 Optus questions the reasonableness of some of the above assumptions. **[Telstra CiC]**
- 5.40 Optus repeats that it is not reasonable to assume a declining forecast demand yet not a declining opex expenditure when the level of opex is primarily demand-driven.

---

<sup>55</sup> ACCC, 2014, Public inquiry into final access determinations for fixed line services – primary price terms, Discussion Paper, July, p.25

<sup>56</sup> Telstra notes that propex is calculated as a proportion of capital expenditure.

<sup>57</sup> Telstra, 2014, Final Access Determinations Inquiry – additional information in response to request under the BBM RKR, February, p.12

## Section 6. Determining prices and price structures

- 6.1 The current FAD prices are based on the recovery of the efficient costs of supply and determined by the revenue requirement calculated under the BBM/RAB approach. As such, the FLSM currently produces a single set of prices within the constraints of the FLSM for each of the declared services.
- 6.2 While there may be some merit in the flexibility to allow prices to be set outside the FLSM, a significant change to the current approach (including changes to the methodology used to set allocations factors) has the potential to undermine the intent of the RAB approach and its objectives to ensure regulatory certainty, a degree of transparency and recovery of the efficient costs of supply.
- 6.3 Optus therefore cautions against a change in the current approach in the FLSM used to set access prices. There are two important questions that must be addressed:
  - (a) Does the current approach fail to set prices at efficient costs?
  - (b) Will a change in the current approach (e.g. through alternative approach or change in pricing structure) address this issue?
- 6.4 This is even more important given recent actions by Telstra to change price structures of regulated services which have the purpose and/or effect of avoiding its regulatory pricing obligations. Given Telstra's dominance in the market, changes in price structures can occur without approval with its customers. There should be no assumption that 'market-based' price structures put forward by Telstra are more efficient than those set by regulation.

### Current approach to setting prices

- 6.5 The current approach to setting prices for the declared fixed line services is currently a function of the service-specific revenue requirement and its associated forecast demand. In general, the outputs of the FLSM (i.e. the final access prices for each declared service) can be found in FLSM tab 'B. Dimensions & Results'.
- 6.6 While the same approach has generally been applied to calculate the access prices from service-specific revenue requirement, there were two exceptions made for ULLS and WADSL. Further adjustments were made to take into account the differences in the price structures for ULLS and WADSL; however, the calculations remain within and as an output of the FLSM.
- 6.7 For ULLS prices, a further adjustment to the service-specific cost in the FLSM was made to determine two separate prices for ULLS using a set of geographic cost relativities. In doing so, a separate price was calculated for each of the ULLS bands and the two final access prices for ULLS calculated as a weighted average price across bands 1 to 3, and a single price for band 4. This calculation is contained in FLSM tab 'D. Geo Cost-based pricing'.
- 6.8 For WADSL prices, a further adjustment to the service-specific cost in the FLSM was made to determine three separate prices for WADSL using a set of cost relativities between the weighted access and usage components of the WADSL service, as well as the geographic cost relativities for the access component. In doing so, relative prices were first determined for the access and usage components then further calculated accordingly. For usage, the final AGVC/VLAN prices have been calculated relative to the forecast AGVC usage; while for access, the final port charges have been calculated as a single price for

Zone 1 and a single price for Zone 2/3. This calculation is contained in FLSM tab 'J. WADSL price structure'.

### **Telstra's proposed 'flexible' approach to setting prices**

- 6.9 Telstra has proposed an alternative approach to setting access prices which relies on both a combination of outputs from the FLSM and the flexibility to set access prices at a point that is between the avoidable cost and the stand alone cost of providing that service.
- 6.10 In particular, Telstra's approach continues to rely on recovering the revenue requirement that is determined in the FLSM – but how this translates into individual service access prices will vary depending on the approach taken to set prices. For example, Telstra's alternative approach is to retain the revenue requirement from the FLSM overall but set access prices for each individual declared service using a yet to be determined methodology outside the FLSM. However, the FLSM will continue to determine prices within the FLSM under the current approach. The final access prices can then be set within a range rather than at a particular point.
- 6.11 Irrespective, the estimates of avoidable cost and standalone cost for each declared service would need to be developed to implement the alternative approach.

### **Merits of moving to a flexible approach**

- 6.12 Moving to a flexible approach would therefore need to meet a number of criteria – namely, the long term interests of end users. However, much of this is already considered within the context of the current FLSM approach.
- 6.13 Price stability in itself should not be the only objective. The ACCC in the last FAD inquiry focused only on price *stability* (and implicitly, the risks of a price increase) and on the legitimate business interests criteria; it did not appear to give weight to the possible impact of a price *decrease* on other criteria, namely the encouragement of efficient investment in infrastructure, and the promotion of ULLS-based competition. In particular, it failed to acknowledge that reduction in the ULLS price had the potential to produce uplift in DSLAM investment and a substantial increase in ULLS-based competition.
- 6.14 Not only would this outcome enhance the quality of fixed line competition (through an increase in ULLS-based competition), but also it would have more lasting effects. By making access seekers more competitive with Telstra in the lead-up to the NBN it would lead to more equitable market shares leading into the NBN transition, impacting the competitive landscape in fixed line telecommunications for years to come.
- 6.15 Irrespective of any approach taken to setting prices, a clear justification must be required for any significant change in existing prices and/or change in the pricing structure for declared services. For example, a lower ULLS price is likely to improve the commercial viability of DSLAM investment and thus has the potential to encourage further DSLAM investment by access seekers. This provides a "clear justification" for such a move.
- 6.16 That said, Optus does not support Telstra's proposed approach to setting access prices that risks diverging (within bounds) from the outputs from the FLSM. If applied it would break the causal link between prices and cost and is likely to create a significant risk of cost over or under recovery. This would not be in the LTIE.

## ULLS pricing

- 6.17 Optus supports the use of a de-averaged ULLS price structure. The FLSM already estimates ULLS prices on an individual basis for each of the ULLS bands 1 to 4.

### Estimating the efficient costs of ULLS

- 6.18 During the 2011 FAD, the existing ULLS Band 2 price at the time was effectively used as a pricing anchor to ensure that price stability was maintained during the transition to the BBM approach.<sup>58</sup>
- 6.19 Optus, however, notes that while this \$16 anchor was considered in 2011 to assist in the transition to the new pricing methodology, the efficient cost of supply if calculated today should reflect a much lower ULLS access price.
- 6.20 The FLSM calculates an averaged ULLS price across all bands, which is then subsequently, deaveraged using a set of cost relativities. Optus considers that this approach should be retained to reflect the geographically differentiated costs of supplying the ULLS. Given there has been no change to the ULLS band structure during the last regulatory period, it accepts that the ULLS cost relativities applied during the last FAD are unlikely to have changed.
- 6.21 Australian market evidence demonstrates that the level of competition has remained largely static and that the development of competition has occurred primarily in the metro areas within bands 1 and 2. Evidence shows that Telstra's share of DSL SIOs remains entrenched above 99% in band 4 and around 60% in the 'competitive' bands 1-3.

### De-averaged ULLS price structure should be adopted

- 6.22 The ULLS price structure continues to be based on a four band structure (Bands 1 to 4). This was the original ULLS product construct, and continues to be the relevant product construct available today. Until the 2011 FAD, ULLS pricing was similarly set at a differentiated rate for each band, and this approach should be reconsidered in this FAD Inquiry.
- 6.23 In the 2011 FAD, the ACCC set an averaged Band 1-3 ULLS price and a separate Band 4 ULLS price. In reaching this decision, it was noted that the average price structure would support investment and competition.<sup>59</sup>
- 6.24 However, Optus reiterates its previous views that this approach disregards the fact that the ULLS is overwhelmingly concentrated in lower cost Band 2 metropolitan areas. This has, over the last FAD period, likely resulted in a substantial over-recovery of revenue from ULLS (above the revenue requirement allocated by the FLSM to be recovered through the ULLS).
- 6.25 Furthermore, the ACCC's considerations in having adopted the 2011 FAD price structure for average Band 1-3 ULLS price have largely failed to eventuate. The ACCC's reasons are summarised as follows:
- (a) *"Since Bands 1-3 share similar characteristics, the aggregation of these geographic regions is appropriate and will support investment and competition."*

---

<sup>58</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.138

<sup>59</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.102

- (b) *“A single price in bands 1-3 will simplify the ULLS price structure and may reduce administrative costs.”*
  - (c) *“The reduction in the ULLS price in Band 3 may promote further DSLAM investment in Band 3 ESAs.”*
  - (d) *“Setting an averaged Band 1-3 price may ease industry’s transition to national wholesale pricing for the NBN and promote industry stability.”<sup>60</sup>*
- 6.26 Optus notes that it has failed to see any significant changes in its take up of ULLS in Band 3 areas, and similarly DSLAM investment in Band 3 areas. Rather, Optus’ experience has been that while the 2011 FAD set a single price for Bands 1-3, this has resulted in no administrative cost changes. Separately, on the issue of ancillary charges (i.e. ULLS connection charges) this has remained subject to differentiated prices on a geographic basis.
- 6.27 Finally, the rationale that setting an averaged Band 1-3 price may ease the transition to NBN in terms of price stability remains ill-conceived. The increase in Band 3 SIOs over the past three years has been extremely minor and is well below the increase in Band 1 SIOs.
- 6.28 Optus is concerned that even though the increase in ULLS SIOs in Band 3 has increased quite significantly on percentage terms, by comparison in absolute terms it has not increased by as many ULLS SIOs in Band 1 areas.<sup>61</sup>

#### **FOAS/FTAS pricing**

- 6.29 The ACCC made significant positive inroads during the last FAD when it confirmed the single, national price structure for PSTN OTA services. Optus therefore strongly supports the continuation of a nationally averaged fixed OTA price structure.
- 6.30 In Optus’ experience, the need for disaggregated charges has not eventuated. Instead, the adoption of the single, national rate for fixed OTA has presented significant benefits compared to the legacy rate table that was in place prior to the last FAD.
- 6.31 In saying that, however, the approach to pricing of fixed termination has lost pace with international developments, efficient network design, and risks becoming inconsistent with mobile termination. All of which threatens to damage competition in related retail markets.
- 6.32 Optus further notes that the regulation of PSTN OTA applies to *all* providers of OTA services. As OTA is a core network service, it is not subject to the same economics of the provision of access lines. Every provider of fixed connectivity has their own market for the termination of traffic – yet the price of such service is based solely on the cost of Telstra’s technology and Telstra’s level of traffic. This needs to be reviewed given the roll-out of NBN-based voice services, and the increasing use of IP technology, results in insignificant incremental costs to deliver the service.

#### **Single, national rate for fixed OTA services should be maintained**

- 6.33 Optus reiterates some of its views in support of the single, national rate for fixed OTA – and submits that many of these views continue to apply. For example, current retail offers reflect the pricing structure of a single, national rate. This clearly evident through the range

---

<sup>60</sup> ACCC, 2011, Inquiry to make final access determinations for the declared fixed line services, Final Report, July, p.102

<sup>61</sup> Over the period from June 2011 to March 2014

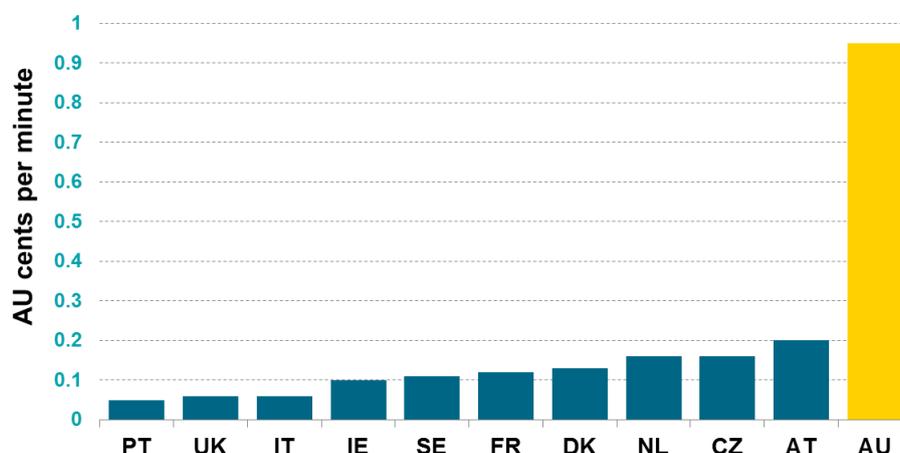
of existing retail offers, which simply offer consumers retail plans with included voice minutes, per call rates, and/or single rates offered on a per minute basis. It continues to be highly unlikely that retail pricing will move in the direction of two-part geographically deaveraged pricing for calls made over fixed line networks.

- 6.34 As previously highlighted, the advent of services such as mobile and VoIP has had dramatic effects on the pricing of fixed voice services, in addition to the effect on distribution and level of fixed voice total. These services are increasingly offering a package up a total value of calls on a national basis rather than charging on an individual call basis.
- 6.35 Therefore, a wholesale price structure that fails to acknowledge retail pricing structures will hamper access seekers' ability to compete in downstream markets.
- 6.36 Third, the PSTN OTA price that is estimated utilising the FLSM should already represent the costs expected to be incurred by Telstra in providing the service. It is therefore within the legitimate business interests of Telstra for a single national rate because such a rate will guarantee cost recovery for Telstra.
- 6.37 Fourth, a single national rate would simplify administrative costs, such as the considerable complexity the ACCC would face in determining a robust geographic estimate of PSTN costs on a RAB basis and rolling these forward from time to time. Reverting back to a geographically de-averaged approach for setting fixed OTA charges is likely to be counter-intuitive, as it would be neither reflective of underlying costs or market conditions.
- 6.38 As such, it is important for wholesale access prices to align with the retail pricing structure; otherwise distortions will arise. Importantly, setting a single national averaged price for fixed OTA serves two important functions: first, it reflects the underlying costs of providing the services; and second, it best enables competitive providers to compete with Telstra, who continues to hold a dominant position in the fixed-line voice market.

The updated FLSM should result in a reduction in the fixed termination rate.

- 6.39 Optus submits that the updated FLSM should result in a reduction in the fixed termination rate. The current PSTN OA and PSTN TA rates have long been set at above cost levels. The impact of this can be seen by comparing fixed termination rates with the latest efficient rates proposed in the European Union (EU).

Figure 7 EU and Australian Fixed Termination Rates



Source: European Commission

- 6.40 The data is striking – Australian fixed termination rate is more than eight times the EU average for efficient rates. Moreover, the Australia rate has not changed for many years. Whereas the EU rates are on a constant glide-path down to the efficient rates shown. There are methodological differences between the Australian and European data, but what is important is that the EU rates reflect efficient, pro-competitive, costs whereas the Australian rates are still set using historic actual incurred costs.
- 6.41 Optus submits that the ACCC should be mindful of the growing difference between the two approaches. Regulation should mimic competitive outcomes. Pricing in competitive markets would reflect a reasonably efficient operator using modern technology. The EU approach assumes that technology such as soft-switches and IP transmission are used to deliver terminating traffic. Optus notes that the vast majority of providers of PSTN OTA in Australia also utilise this technology. Telstra should not be rewarded for its failure to deliver voice services using the most efficient technology.
- 6.42 In so far as there is scope for the ACCC to take this into account when setting allocation factors, it should be done. For example, given the growth of data in modern fixed line core networks, it seems improbable that IP based voice products are allocated the same share of costs from shared assets. This can be compared with the pricing of mobile termination, which has seen a dramatic decline due to the growth of mobile data. Further, the ACCC needs to consider the impact of NBN migration on costs of termination as an increasing proportion of calls will be carried as an IP stream, at insignificant incremental costs.

*Fixed line FAD take into account impact on mobile market*

- 6.43 Optus submits that the ACCC should consider the efficient use of infrastructure and impact on competition in both related downstream fixed and mobile call markets. The ACCC has consistently observed that fixed and mobile services are compliments to one another – the majority of end-users have both a fixed and mobile connection. The decision to call a mobile or fixed line number will in part be influenced by the price of the call. A factor for outbound call charges is the applicable termination charge. When different cost methodologies are applied, inefficient call decisions may result. For instance, given the different cost approaches, the fixed rate would be relatively higher and would impose higher calls charges on MTF calls.<sup>62</sup>
- 6.44 Consequently, Optus believes that the ACCC should consider the need for equal treatment of fixed and mobile termination services so as to remove any potential bias towards one network over another.
- 6.45 Consistency of cost methodology between fixed and mobile termination services removes any regulatory distortions and enables end-users to make calling decisions based on the true efficient costs of the termination services. For example, the European Commission (EC) has adopted a common cost methodology across both fixed and mobile termination services.<sup>63</sup> The EC states:

***Significant divergences in the regulatory treatment of fixed and mobile termination rates create fundamental competitive distortions. Termination markets represent a situation of two-way access where both interconnecting operators are presumed to***

---

<sup>62</sup> For the same cost base, fully allocated cost method includes a greater number of costs than included in incremental cost methods. For example, all costs are allocated to the relevant service rather than costs that are incremental to the provision of the service. The level of network optimisation may also differ between the cost approaches.

<sup>63</sup> See EC, Recommendation of 7.5.2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU, C(2009) 3359 FINAL

*benefit from the arrangement but, as these operators are also in competition with each other for subscribers, termination rates can have important strategic and competitive implications. **Where termination rates are set above efficient costs, this creates substantial transfers between fixed and mobile markets and consumers.***<sup>64</sup> [emphasis added]

- 6.46 This is not to say that FTR and MTR should be equal. Network reality is that FTR should always be less than MTR when using the same cost methodology. Both MTR and FTR include core-related network costs. In both networks, core costs are relatively close as modern telecommunications networks are moving towards having common all-IP core networks. However, FTR do not include any access network components (i.e. last mile copper line) as these costs are not driven by the level of traffic. On the other hand, mobile access network components are allocated to MTRs (i.e. BTS costs, backhaul links) as mobile access networks are dimensioned to provide suitable levels of busy hour capacity — which includes the level of termination traffic. Optus notes that where a consistent cost methodology is used to determine the costs, results in MTRs that remain significantly greater than FTRs.

#### Fixed termination must remain below mobile termination

- 6.47 As discussed above, using the same cost methodology, FTRs should remain significantly below MTRs. European evidence clearly demonstrates that under a common LRIC methodology, MTRs remain around nine times higher than FTRs. However, Optus is concerned that the use of significantly different cost methodologies between FTRs (using a top down allocated historic cost method) and MTRs (using either LRIC or LRIC+) will result in MTRs that approach, or fall below FTRs. Such a result does not represent differences in the efficient cost of supply; rather the differences would arise because of varying regulatory approaches.
- 6.48 As a result, consumption of related downstream products and investment signals would be based upon regulatory decisions and not the efficiency cost to supply both services. Such an outcome does not promote the LTIE, nor does it promote competition in related markets, nor will it promote efficient use of, and investment in, infrastructure.
- 6.49 Further, it would represent a significant subsidy from mobile operators to the dominant fixed operator — a FTR of 0.95cpm is more than eight times higher than the EU LRIC average. It would represent a transfer from the competitive mobile market to the dominant fixed market. Telstra remains the dominant horizontally integrated fixed and mobile operator. Telstra does not ‘pay’ FTRs as it owns both the originating mobile network and the terminating fixed network.
- 6.50 As a result, there would be a subsidy away from mobile consumption towards fixed usage. As noted by the ACCC, most end-users have both mobile and fixed connections. They are complimentary services. When faced with the option of making calls from and to either a mobile or fixed number, the underlying cost of the call impacts the decision. Efficiency requires that call price reflect the marginal cost of provision. This is not possible for calls terminating on fixed networks. The cost to call a fixed network from a mobile network is likely to be 60% above the efficient costs to do so. Whereas calls from fixed to mobile will reflect the efficient costs.<sup>65</sup> There will, therefore, be an incentive for end-users to makes

---

<sup>64</sup> EC, Recommendation of 7.5.2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU, C(2009) 3359 FINAL, p.3

<sup>65</sup> MTF calls incur efficient costs of 1.3cpm for mobile origination (assume origination equals termination) and efficient cost of 0.1cpm to termination on fixed. But the termination charge would be 0.95cpm. Total cost charges equals 2.25cpm and the efficient cost is 1.4cpm. Represents a 60% mark-up over the efficient costs.

calls from fixed numbers rather than mobiles. And this incentive is not based on the relative costs of the service, but rather the impact of FTRs set above the efficient level.

## Wholesale ADSL pricing

- 6.51 A key reason for the declaration of the WADSL service is to promote the LTIE during the transition to NBN. This would include setting the appropriate price signals for access to the WADSL service:

*The ACCC considers availability of wholesale ADSL services on reasonable terms while the NBN is being deployed as important to the development of effective retail-based competition in the medium to long term. This is primarily because regulated wholesale ADSL could potentially enable access seekers to effectively compete with Telstra for retail customers.<sup>66</sup>*

- 6.52 Notably, whilst there may be competing ADSL networks available: *“The reach and functionality of these other networks differs greatly between operators with providers other than Telstra having much smaller ADSL footprints than Telstra... the supply of wholesale ADSL services is highly concentrated with Telstra as the dominant provider.”<sup>67</sup>*

- 6.53 Optus therefore welcomes the opportunity to reassess the pricing structure of WADSL. As highlighted in previous submissions, there were concerns that the WADSL rates set in the FAD were set at rates inconsistent with the competitive price of supply.

### Pricing structure for WADSL

- 6.54 Optus submits that should the two-part pricing structure be retained, the rates should more closely align with the efficient costs of supply. Furthermore, that the key components of the WADSL service be provided on a more transparent basis.
- 6.55 The FLSM currently allocates total monthly WADSL costs between port and AGVC charges using a ratio determined in the WADSL IAD. This however has effectively resulted in access prices that are inconsistent with the LTIE for a number of reasons:
- (a) First, the pricing structure does not promote competition uniformly during the transition to NBN. Telstra continues to be able to leverage its dominant position in the supply of WADSL in non-competitive areas.
  - (b) Second, the level of prices is still too high. For example, the cost of WADSL is significantly greater than the costs of competitive providers to supply an equivalent service using ULLS.
  - (c) Third, the WADSL service requires the purchase of non-regulated services as a mandatory feature. That is, the regulated prices do not cover the full suite of products that must be purchased to resell WADSL from Telstra.
- 6.56 In particular, Optus had previously highlighted concerns that the ‘declared’ WADSL service should capture each and all of the necessary components required to provision/access the DSL service. During the 2012 declaration inquiry, Optus expressed concerns that ‘to regulate a wholesale ADSL service without incorporating the AGVC/VLAN service would

---

<sup>66</sup> ACCC, 2012, Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010, Final Decision, February, p.44

<sup>67</sup> ACCC, 2012, Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010, Final Decision, February, p.4

provide Telstra with the opportunity to use VLAN pricing to deter access seekers from accessing the DSL service.’ This issue has since eventuated.

6.57 For example, as highlighted in Optus’ submission to the Non-Price FAD discussion paper, the Telstra Business Grade Ethernet (TWBGE) product is a compulsory requirement for the provision of WADSL services. TWBGE provides access seekers with Ethernet access to Telstra’s Internet Gateway Routers.

6.58 During the regulation of the WADSL service, little mention was made of the compulsory TWBGE charge. The WADSL service was described as:

*The backhaul interface can be either an AGVC or VLAN (using either ATM or Gigabit Ethernet as the transport protocol respectively). The access seeker acquires an interface and then acquires capacity over that interface to a specified throughput that it chooses. [As such] In acquiring a wholesale ADSL service an access seeker must pay both a ‘port charge’ for the local access component and a variable AGVC charge for the backhaul component.<sup>68</sup>*

6.59 An access seeker is required to purchase a port charge and AGVC/VLAN charges only to acquire a WADSL service (both of which have price terms as set out in the 2013 WADSL FAD). However, to resell a WADSL access seekers are required to purchase the underlying Ethernet port and link capacity, as well as the VLAN charge and the monthly charge per end-user port. In addition to the monthly recurring charge, there are additional set-up and connection charges.

6.60 **[CiC]**. Optus is concerned that this solution has the potential to bypass the intent of the WADSL declaration, by offering an alternative ‘backhaul’ solution that both utilises the same network components but under a construct that allows it to price it outside the remit of the FAD.

6.61 A similar behaviour was observed in the wholesale transmission market, in which Telstra introduced a new Managed Leased Line (MLL) product that effectively replicated the declared Domestic Transmission Capacity Service (DTCS) but under a new pricing construct based on a route matrix. It is not inconceivable that Telstra would again adopt this avoidance tactic.

6.62 This issue is more important given the nature of the BBM and the allocation of network costs to services. If the FLSM allocates all costs associated with network elements used to supply WADSL to the WADSL pricing components, there can be no further non-regulated network services be required to supply the service. It would appear that Telstra is over-recovering the costs to supply, or at least including network elements into the regulated charges that are actually covered by the TWBGE or the new DSL backhaul product.

6.63 Optus submits that the ACCC should ensure that Telstra does not avoid its regulatory obligations and that Telstra cannot require the purchase of other non-regulated services in order to receive the regulated product.

### Geographic pricing for WADSL

6.64 The ACCC has previously acknowledged that the wholesale market for ADSL is not competitive, and that “The structure of Telstra’s wholesale ADSL pricing has also been the

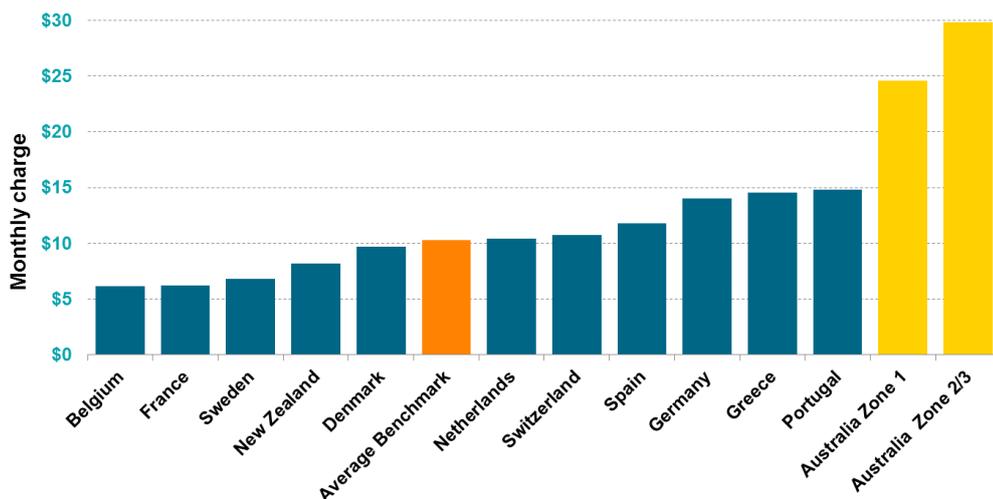
---

<sup>68</sup> ACCC, 2012, Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010, Final Decision, February, p.5

source of competition concern.”<sup>69</sup> At a wholesale level, Telstra charges access seekers different prices for ports in different geographic areas. As such, it is understood that Telstra has characterised its ESAs into ‘Zone 1’ or ‘Zone 2/3’ based on the availability of competitive infrastructure. Further, unlike ULLS bands, which are based on objective criteria, ESAs are classified into zones at Telstra’s own discretion.<sup>70</sup>

- 6.65 Given the two-part pricing structure for WADSL based on differential pricing for port charges and a single rate for AGVC/VLAN usage, the port charges should still adhere to meeting efficient costs (i.e. the underlying costs of supply). The same observations made by the ACCC in the 2012 declaration unfortunately remain relevant.<sup>71</sup>
- 6.66 Optus repeats its previous comments that the current level of port charges remains too high. To this end, Optus reiterates that the use of benchmarking provides a useful check as to whether the output prices from the ACCC’s modelling reflect efficient ADSL costs. Benchmarking is particularly helpful for the ADSL port charge, as this includes only equipment cost, which should not vary significantly between countries. The table below provides benchmarks from a number of European markets and New Zealand. This shows that the WADSL product in Europe ranges from a monthly charge of \$6.16 to \$14.81 (with an average of \$10.30, inclusive of New Zealand in the benchmark set). This is well below the equivalent WADSL rates in Australia.<sup>72</sup>

Figure 8 Wholesale ADSL benchmark prices



Source: Various National Regulatory Agencies (NRAs)

- 6.67 In general, Optus considers that access charges should be levied on a nationally consistent basis. This is in line with the expectation that in the wholesale broadband market, wholesale customers often require national coverage. This is to allow them to supply retail customers in both metropolitan and regional areas.
- 6.68 This would also be consistent with Telstra’s condition on access seekers that WADSL must be purchased together as a bundle with WLR. Telstra has previously argued that this is a

<sup>69</sup> ACCC, 2012, Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010, Final Decision, February, p.35

<sup>70</sup> ACCC, 2012, Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010, Final Decision, February, p.35

<sup>71</sup> ACCC, 2012, Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010, Final Decision, February, p.36

<sup>72</sup> Refer to Optus, Additional information on comparable wholesale ADSL rates in Europe & New Zealand, Letter to ACCC, 17 April 2013

*condition "...because of Telstra's core systems and platform design, ADSL services can only be provisioned when a telephone line has been provisioned at the end-user's premises. That core systems/platform limitation applies to both wholesale and retail services."*<sup>73</sup>

---

<sup>73</sup> Telstra, Letter to the ACCC Discussion paper into whether wholesale ADSL services should be declared under Part XIC of the Competition and Consumer Act 2010 –Access Seekers' Submissions, 8 February 2012

## Appendix A. Economic efficiency during transition to NBN

- A.1 The legacy copper network is being replaced by the NBN during the timeframe of this FAD. Consequently, setting access pricing for declared fixed line services must increasingly be viewed in the context of the transition to NBN. Unique to this situation is that the legacy copper network will effectively be shut down and replaced with a government-owned statutory monopoly – thus removing the requirement for commercial investment. To Optus' knowledge this is unprecedented worldwide. As such, there is little, if any, regulatory principle to guide the ACCC. The ACCC should therefore be guided by economic first principles.
- A.2 This appendix discusses the trade-offs in relation to promoting competition and infrastructure investments, and how previous views by the ACCC on efficiency should be refreshed to take into account the shutdown of Telstra's network across Australia.
- A.3 Finally, it will show that the LTIE will be best promoted if a greater weight is placed upon increasing static efficiency through a pricing regime that focuses on promoting competition rather than incentives to invest. Since there is no need to further invest in the copper network, very little efficiency in a dynamic sense will be gained from maintaining the existing pricing regime which was designed to encourage infrastructure investment in the legacy network.

### Impact on the assessment of the long term interest of end-users

- A.4 The legislative criteria requires that when making an access determination, the ACCC must take the following matters into account:<sup>74</sup>
- (a) Whether it will promote the long term interest of end-users;
  - (b) The legitimate business interest of access providers and the access provider's investment in facilities used to supply the service;
  - (c) Interests of all persons who have a right to use the declared service;
  - (d) The economically efficient operation of a service, network or facility;
  - (e) Value of extensions and the operational and technical requirements necessary for the same of reliable operation of a service, network or facility.
- A.5 When considering whether something promotes the LTIE, regard must be had to the following objectives:<sup>75</sup>
- (a) Promoting competition in relevant markets;
  - (b) Achieving any-to-any connectivity;
  - (c) Encouraging the efficient use of, and the economically efficient investment in, infrastructure by which services are supplied, including;
    - (i) the legitimate commercial interests of the access provider

---

<sup>74</sup> Section 152BCA

<sup>75</sup> Section 152AB

(ii) incentives for investment

- A.6 While the Act contains a long list of considerations that the ACCC must have regard too, there are some key factors which impact across several matters.
- A.7 The primary objective of access regulation is to promote competition. This is concerned with enabling efficient suppliers to operate in dependent markets, to gain the benefits of the process of competition such as lower prices for consumers and displacement of inefficient suppliers by efficient suppliers.<sup>76</sup> One reason for the primacy of the promotion of competition is that it enhances economic efficient outcomes and consumer welfare — in simple terms competition is the force that leads to efficiency and monopoly is condemned for distorting it.<sup>77</sup>
- A.8 Another key element is the efficient use of, and investment in, infrastructure used in the provision of declared services. Access providers will have an incentive to make efficient incentives so long as it receives a normal return on the investment.<sup>78</sup> This requires that a carrier can recover the costs of its infrastructure, its operating costs and obtain a normal return on its capital.<sup>79</sup>
- A.9 It has been recognised that one purpose of access pricing is to provide the incentives for the access providers to find the least cost way of providing the services (now and into the future) by promoting competitive forces. Failure to do so would lead to reductions in in productive and dynamic efficiency in a way that would not promote the economically efficient operation of telecommunications networks and infrastructure now and in the future.<sup>80</sup>
- A.10 It is clear that the common elements across the main matters to be considered are the promotion of economically efficient outcomes — both usage and investment. One could argue that if a FAD promoted economically efficient outcomes then it promotes the LTIE and other matters. Much discussion has occurred on what is efficiency in the context of Part XIC.
- A.11 Decisions made during a FAD Inquiry will need to balance the short term interest of end-users (promote competition, lower prices, increased usage) and the longer-term interests (ongoing access to services, reinvestment, new products and services, new networks). Short term interests, such as lower prices, is bounded by the requirement to cover direct costs of providing access and the legitimate commercial interests of access providers. Longer term interests, such as adequate return to encourage investment, is bounded by concepts of efficient investment and long term competition by access seekers.
- A.12 Given this is the first time under Part XIC where the ACCC is to consider the LTIE within the context of shutting down a network and migration to a wholesale only government funded national network. Optus believes that there is little guidance in the outcomes of previous decisions. Rather, the ACCC should be guided by the application of economic principles to the unique factors as a result of the migration from legacy copper network to next generation fibre networks.
- A.13 The remainder of this paper examines:
- (a) elements of economic efficiency;
  - (b) maximising efficient in absence of need for reinvestment; and

---

<sup>76</sup> Re Telstra Corporation Ltd (No 3) [2007] ACompT 3 (17 May 2007), [98-9]

<sup>77</sup> Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009), [1]

<sup>78</sup> Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [103]

<sup>79</sup> Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [104]

<sup>80</sup> Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [95]

- (c) Its application to the current FAD considerations.

## Elements of economic efficiency

- A.14 Textbook economics defines economic efficiency into three main types: allocative (i.e. Pareto), productive (i.e. technical) and dynamic efficiency. The Australian Competition Tribunal has expressed this as:

*There is productive efficiency, allocative efficiency and dynamic efficiency. Productive efficiency is production at least cost. Allocative efficiency occurs when services are provided to those who value them most highly. Dynamic efficiency involves preserving incentives for innovation and investment.<sup>81</sup>*

- A.15 Allocative and productive efficiency demands that efficiency be promoted within the current period, maximising usage of the current assets and access prices set at marginal cost without regard to sunk investments. The Australian Competition Tribunal has commented that productive and allocative efficiency related to “*the most efficient use of the resources and technology currently available to a firm, in **any given time period.***”<sup>82</sup> [emphasis added]

- A.16 Further, allocative efficiency will be “*best promoted where the price of a service reflects the underlying marginal cost of providing the service.*”<sup>83</sup>

- A.17 In the context of fixed line pricing, the UK regulator Ofcom stated that:

*Allocative and productive efficiency are served if prices are set on the bases of forward-looking costs (strictly, marginal cost), and sunk costs play no part in this measure.<sup>84</sup>*

- A.18 A sunk cost is an expenditure that has been made and cannot be recovered; investment expenditures are sunk costs when they are firm or industry specific.<sup>85</sup> One important aspect of telecommunications is the high sunk cost of building a network, prior to producing services and obtaining revenue. Once investment has incurred, a supplier should ignore the cost of a sunk asset in deciding whether to continue to produce a service. As long as the revenue received for the service exceeds the non-sunk costs of producing the service, the firm is better off continuing to supply the product.

- A.19 Dynamic efficiency is a concept that involves consideration of adaptation by firms to the evolving supply and demand forces in the market.<sup>86</sup> It involves two elements:

- (a) preserving incentives for innovation and investment;<sup>87</sup> and
- (b) ensuring ongoing competition which forces firms to seek to improve their goods or develop new goods as part of the battle<sup>88</sup>

- A.20 This view is also adopted by Ofcom, where it identified two elements to dynamic efficiency: the first relates to investment and innovation by the *regulated firm*; and the second relates

---

<sup>81</sup> Re Duke Eastern Pipeline Pty Ltd [2001] ACompT 2 (4 May 2001), [63]

<sup>82</sup> Re Qantas Airways Ltd [2004] ACompT 9 (12 Oct 2004), [160]

<sup>83</sup> Re Telstra Corp Ltd [2006] ACompT 4 (June 2006), [94]

<sup>84</sup> Ofcom, 2011, Charge control review for LLU and WLR services, Annex 5. Available at:

<http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/annexes/wlr-cc-annexes.pdf>

<sup>85</sup> Pindyck, R.S., “Sunk Costs and Real Options in Antitrust Analysis”, 1 *Issues In Competition Law And Policy* 619

<sup>86</sup> Re Qantas Airways Ltd [2004] ACompT 9 (12 Oct 2004), [159]

<sup>87</sup> Re Duke Eastern Pipeline Pty Ltd [2001] ACompT 2 (4 May 2001), [63]

<sup>88</sup> Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009), [33]

to competitive entry of *alternative providers* and the additional competitive pressure to reduce costs over time.<sup>89</sup>

- A.21 Dynamic efficiency takes into account investment decisions by the access provider, now and in the future. This requires that regulated prices be set at levels allowing recovery of efficient investments (irrespective of whether they are sunk). Specifically, dynamic efficiency takes into account the trade-off between short term and middle (or long) term dimensions in order to guarantee adequate returns to an investment.
- A.22 While sunk costs are irrelevant for static efficiency considered, they are an important consideration in production decisions. The possibility of recovering the investment and making an adequate return is a key part of the investment decision. A rational owner of capital would not reinvest in the same sunk assets if it has not recovered, or expects that it could not in the future recover, the cost of investment (including an adequate return).
- A.23 Dynamic efficiency also looks at competitive entry and the additional competitive pressure to reduce costs over time. This takes into account the chilling effect on competitive investment as a result of high access prices leading to less-than-optimal levels of independent infrastructure investment.<sup>90</sup> Higher access prices would promote further investment by access providers, but may also discourage competitive investment by access seekers.

### Maximising efficiency in in absence of reinvestment

- A.24 Setting regulated prices that maximise efficiency depends on whether one looks at efficiency within one investment period (static efficiency) or across multiple investment periods (dynamic efficiency). For example, ignoring sunk costs is efficient in a static sense, but it would not promote dynamic efficiency and incentives to invest.<sup>91</sup>
- A.25 A classic example of the relationship between static and dynamic efficiency is access regulation based on a simple cost recovery rule, which encourages efficient utilisation of infrastructure through close to marginal cost pricing, but risks discouraging future investment. For example, in relation to the recovery of duct investment in the UK, Analysys Mason stated:

*... allocative efficiency would be achieved by pricing at the incremental costs. In the case of duct, where so much of the investment is sunk and where additional (spare) capacity is commonly deployed at the time of the initial build, these incremental costs can be very low. Accordingly, even allowing for some new construction costs, incremental costs will be likely to be substantially below the fully allocated current replacement cost or [LRIC] (and indeed below HCA FAC).<sup>92</sup>*

- A.26 Similarly, in relation to efficient local loop access pricing in the presence of declining demand, Neumann and Vogelsang have noted that *“since a large portion of the copper-related costs are sunk and therefore overcapacities develop, true forward-looking costs will therefore be much lower than LRIC as traditionally calculated”*.<sup>93</sup>

---

<sup>89</sup> Ofcom, 2011, Charge control review for LLU and WLR services, Annex 5. Available at: <http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/annexes/wlr-cc-annexes.pdf>

<sup>90</sup> Application by Telstra Corp Ltd [2009] ACompT 1 (22 May 2009), [156]

<sup>91</sup> Ofcom, 2011, Charge control review for LLU and WLR services, Annex 5. Available at: <http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/annexes/wlr-cc-annexes.pdf>

<sup>92</sup> Analysys Mason, 2010, Alternative methodologies for the valuation of BT’s duct assets, p.23

<sup>93</sup> Neumann, K.-H., Vogelsang, I., 2013, ‘How to price the unbundled local loop in the transition from copper to fiber access networks?’, Telecommunications Policy, Vol. 37/10 (2013), pp.893-909

- A.27 Marginal cost pricing is efficient in these examples because there is no need to reinvest in the network asset. In the duct example this is because of the enduring nature of the investment (where marginal cost covers ongoing maintenance charges) and in the copper local loop example, it is the impending migration to fibre access.<sup>94</sup>
- A.28 Under both static and dynamic criteria, the main purpose for regulating the telecommunication markets is to induce efficiency – that is, enhancing competition.
- A.29 In the static sense, competition reduces the market power of producers (or a sole ‘producer’ of access infrastructure such as Telstra), which leads to lower prices and higher consumer surplus. Competition also disciplines producers in their use of resources thereby promoting efficient use of inputs and minimising waste. As noted above, a price which reflects marginal cost maximises allocative and productive efficiency. It will also be that access pricing that reflects marginal cost best promotes competition in a dynamic sense – that is, it both access seekers and access provider will face the same cost of access to legacy copper networks during transition to NBN. Both access seekers and access provider will be able to attract end-users on the same cost basis – and win or lose customers on the efficiency of their own operations. This will not only promote competition during transition to NBN, but better reflect the nature of competition post-migration, where all providers will have access to the same open access fibre network.

### **Relevance to the current FAD Inquiry**

- A.30 The key element when setting terms of access that promote the LTIE is to promote efficiency in both a static and dynamic sense. Pricing that promotes competition (i.e. close to marginal cost) does this in a static sense, and also promotes competition in a dynamic sense. When dynamic considerations take into account the incentives to invest, and reinvest, especially with sunk assets, prices must be sufficient to ensure adequate return to capital. This implies a price higher than marginal cost.
- A.31 Promoting the LTIE has traditionally been a balancing act of these often conflicting objectives. In the current context of fixed line access pricing during migration to NBN, the trade-off between static and dynamic efficiency is less apparent. The ACCC might wish to reconsider the weight given to static efficiency in pricing decisions.
- A.32 Where considerations relating to continual investment in copper infrastructure in the long term are no longer relevant, marginal cost pricing would best promote competition and economic efficiency in both a static and dynamic sense.

---

<sup>94</sup> Neumann & Vogelsang discuss issues around efficient copper access pricing while ensuring sufficient investment incentives for incumbent operators to reinvest in fibre networks. There is not the same issues in Australia where the Government is funding the deployment of NBN. Hence, access pricing of copper does not need to consider signals for reinvestment in next generation networks by the incumbent copper provider.