

**Optus Submission to  
Australian Competition and Consumer Commission  
in response to discussion paper  
Telecommunications Access Pricing Principles for Fixed Line Services**

**February 2010**

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## 1. Executive Summary

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- 1.1 Optus welcomes the ACCC's decision to review its access pricing principles for fixed line services. This is a very significant review. The decisions taken by the ACCC following this review are likely to have a material impact on future access prices not only for services on Telstra's Copper Access Network (CAN), but also for services that will be delivered over the National Broadband Network.
- 1.2 The ACCC's current pricing principles for fixed line services which recommend the adoption of a replacement cost approach were put in place in 1997. It is entirely appropriate that the ACCC reviews the continued rationale for this approach and asks the question whether alternate approaches are more likely to meet the competition objectives of the Trade Practices Act.
- 1.3 In this submission Optus will argue that the current approach has become increasingly detached from the legislative objectives set out in the Trade Practices Act. In particular, it appears to place too great an emphasis on "investment incentives" as the means to promote the long term interests of end-users. Such an emphasis is no longer appropriate given the widespread recognition that duplication of Telstra's CAN infrastructure by access seekers is neither efficient nor likely to occur. This conclusion is only reinforced by the anticipated deployment of the National Broadband Network throughout Australia with the anticipated eventual closure of large parts of the Telstra CAN.
- 1.4 In practical terms, a core problem with the current approach is that it results in an annual upward revaluation of Telstra's assets that inevitably leads to higher and higher access prices on the CAN. Such prices are simply not justified, since they compensate Telstra for costs it never incurred nor will incur. As the ACCC itself has recognised, the current approach; "*allows for the costs of a replacement asset to be reflected in access prices without requiring that investment in the replacement asset to actually take place*".
- 1.5 To put this into some perspective the current replacement cost of Telstra's ducts has been calculated at 343 per cent higher than the actual costs to Telstra in deploying those ducts.<sup>1</sup> Telstra is unlikely to replace those ducts yet it is the replacement value that is used to set access prices. If the current methodology is rolled forward then ULLS Band 2 prices are likely to have increased 92% over the period 2005-06 to 2011-12 (a CAGR of 11.5%). By over compensating Telstra in this way it could be argued that the current approach breaches the objectives of the Trade Practices Act since it both distorts efficient investment incentives and stifles competition.
- 1.6 Optus considers that Telstra's assets should be valued in a more realistic manner for the purposes of setting access prices for fixed line services. A

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<sup>1</sup> ACCC, January 2009, *Assessment of Proposals, Report to Expert Panel*, Confidential Version, p.p.59-60

very critical component of any new approach is to ensure that appropriate regard is given to the age of Telstra's assets and the fact that it has already recovered much of the original construction cost. Put simply, Telstra should face the same economic realities of every other business that depreciable assets cannot generate the same value as brand new assets and as such the special status accorded to its assets should be removed.

- 1.7 In setting an appropriate asset valuation, there are clearly a number of alternate approaches that could be adopted, other than the current replacement cost approach. In this submission Optus has examined a number of these different approaches. In considering each of these the ACCC will need to carefully review the relevance of each of these against both the statutory criteria and the practical considerations of implementing each methodology. Ultimately, the Pricing Principles adopted by the ACCC should aim to meet three key tests:
- To enable Telstra to recoup its prudent investment in the CAN;
  - To enable access prices to be clearly linked to actual costs incurred or likely to be prudently incurred: and
  - To be clear, transparent and practical – that is, the approach should be capable of being readily implemented.
- 1.8 In this submission Optus will argue that application of a Depreciated Actual Cost (“DAC”) Pricing Principle best meets the above criteria. Such a valuation will reflect the price Telstra paid to deploy the CAN. Implicitly, therefore, prices set on the basis of DAC will reflect Telstra's costs and enable Telstra to recoup its investment plus a reasonable regulated rate of return. A DAC valuation can also be readily determined since it can be sourced directly from Telstra's regulatory accounting records. Whilst Optus considers that other approaches may also be reasonable – such as the application of a Depreciated Optimised Replacement Cost methodology – we would be concerned with the practical implications of establishing such a valuation. It would likely see the perpetuation of the current “battle of the models” and litigation that has so bedevilled the application of the present approach.
- 1.9 In summary, Optus submits that the application of the current Pricing Principles to the Telstra CAN is no longer justified. It is in the interests of competition and end-users that an alternate approach is adopted that better aligns access prices to the costs Telstra has and will incur. By taking account of historic depreciation this will ensure that Telstra is not able to recoup the costs of its assets several times over.
- 1.10 The ACCC has asked for stakeholders' views on a number of specific issues. In response, Optus submits that:
- The capital value of Telstra's network assets should be “locked in”, rather than re-valued periodically (as under the current system). This move would greatly improve certainty in pricing and would thereby

facilitate business planning and investment decision-making by all telecommunications industry players.

- The ACCC should take into account the historic depreciation of Telstra's network assets for the purposes of placing a value on those assets for pricing purposes. Failure to recognise past compensation would allow Telstra to recover its network costs many times over by overcharging access seekers (and ultimately end users).
  - The ACCC has canvassed views on whether mechanisms should be built into the pricing approach to reward Telstra for incurring capex and opex "efficiently". Whilst such an approach may have theoretical merit it is open to gaming and overcharging. Optus opposes such a mechanism. Similarly, Telstra should not be allowed flexibility in pricing individual services (for example, within the broad limit a price cap mechanism). As a vertically integrated operator this would provide Telstra with the opportunity to discriminate against its retail competitors. Optus submits that the ACCC should set prices for all individual regulated services on the CAN. In setting such prices, Telstra should be allowed to recover its actual capex and opex subject to the ACCC's satisfaction that such expenditure was prudent.
  - A key issue raised by the ACCC concerns the geographic nature of access prices. Optus submits that ULLS prices should continue to be set on a de-averaged basis recognising that investment in DSLAM technology was made in reliance on this approach, which had been approved by the ACCC. By contrast it would be appropriate to remove the arcane and overly complex pricing structure for PSTN Originating and Terminating Access and, consistent with the approach that applies to termination of mobile voice calls, move to a single national rate.
  - In the event that the proposed reforms to the ACCC's pricing principles would cause substantial changes to the levels of individual access prices, an initial transition period would be appropriate. Prices should be smoothed out over time in order to avoid rate shocks that would disrupt business and investment planning.
- 1.11 Finally, Optus considers that it will be important for the ACCC to consider the implications of a potential deal being negotiated by Telstra to migrate its traffic to the NBN and to allow NBNSCo to access its duct network. Such a deal, if it eventuates, may involve significant consideration being paid to Telstra (in one form or another) for effectively closing down large parts of its CAN. Whilst it would be premature for the ACCC to speculate on the details of such a deal it would nevertheless be appropriate for it to signal that any consideration Telstra receives will be taken into account to ensure there is no risk of over-recovery. Further, the ACCC should signal that access prices will not rise as a result of any deal negotiated and agreed to by Telstra.

## 2. Background

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- 2.1 The current consultation on pricing principles for fixed line services is a very important and welcome review. The ACCC's principles for setting prices for wholesale access services on Telstra's fixed line network were put in place in 1997. It is now timely to review those principles.
- 2.2 At the time the 1997 pricing principles were published, there was a strong expectation that competition based on alternative fixed line infrastructure networks would deliver outcomes that were in the long term interests of end users. It was thought that valuing infrastructure at its replacement cost would generate prices that would provide investors with correct signals concerning whether to build their own infrastructure to provide services, or to purchase access to the existing infrastructure.
- 2.3 For this reason, the ACCC has set access prices for key services including ULLS based on valuing Telstra's network assets at 'optimised replacement cost'. This method involves revaluing network assets at the cost of replacement with modern equivalent assets, using a cost model which designs a hypothetical optimised network (as opposed to compensating Telstra for the costs it has actually incurred). No allowance is made for the age or condition of the existing network.
- 2.4 The ACCC's views on the desirability of replacement cost pricing (as opposed to historic cost) and on the primacy of investment incentives have recently shifted. As the ACCC notes in its discussion paper:
- "...the concerns expressed in the 1997 Pricing Principles Guide — that measuring the costs of this infrastructure on a historic, rather than replacement cost, basis would lead to inflated access prices which would encourage inefficient bypass — may, in hindsight, have been overstated, given that the cost of replacing the infrastructure has been rising."*
- 2.5 Moreover, it is clear that the current pricing approach – and its over-emphasis on investment incentives – has caused significant problems. Repeated revaluation results in significant uncertainty over the level of the access price in each regulatory period. Fluctuations in the price of copper alone can be expected to result in an annual error of around 20%.<sup>2</sup>
- 2.6 Asset valuation at replacement cost compensates Telstra 'as if' it had constructed a new modern network, and so provides compensation for 'hypothetical' expenditure that Telstra never actually incurred. It treats Telstra's depreciated copper network assets as if they were brand new. This causes a significant overvaluation; eg, the current replacement cost of Telstra's ducts is 343 per cent higher than the actual costs Telstra incurred in deploying those ducts.<sup>3</sup>

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<sup>2</sup> CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, pp.22-23

<sup>3</sup> ACCC, January 2009, *Assessment of Proposals, Report to Expert Panel*, Confidential Version, p.p.59-60

- 2.7 Replacement cost pricing ignores the fact that Telstra has already recovered much of its original investment, effectively allowing double returns on its investment. The ACCC has recognised this, noting that:

*“[b]ecause these recovered costs are never taken into account, the period over which Telstra is able to recover its investment costs on these assets is, in effect, never-ending”<sup>4</sup>*

- 2.8 Another problem with the current approach is that it results in an annual upward revaluation of Telstra’s assets that inevitably leads to higher and higher access prices on the CAN. This has a significant flow-on impact on the business of access seekers and on end user pricing. When Optus made its original commitment to invest in ULL based access in September 2005 it did so in part because it had confidence that the ACCC would deliver access prices that would render the investment case for ULLS sustainable. Since 2005, there has been significant investment in fixed line voice and broadband services. Consumers are now starting to see the fruits of this policy with increased competition in the market and real choice. This has driven important benefits to consumers – through lower prices, improved quality of service and greater innovation.
- 2.9 However, the annual upward revaluation of Telstra’s assets caused by the current pricing regime is putting these competitive gains at risk. The ULLS investment case remains highly sensitive to access prices, as Optus demonstrated in its October 2009 submission on fixed line pricing principles.<sup>5</sup> If the current methodology is rolled forward then ULLS Band 2 prices are likely to have increased 92% over the period 2005-06 to 2011-12 (a CAGR of 11.5%).<sup>6</sup> These prices would put significant pressure on access seekers’ ULLS investment plans and would likely lead to less competitive intensity and worse outcomes for consumers.
- 2.10 Optus considers that it is entirely appropriate that the ACCC reviews the continued rationale for its current replacement cost pricing approach and that it asks the question whether alternate approaches are more likely to meet the competition objectives of the Trade Practices Act.

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<sup>4</sup> ACCC, National broadband network: Regulatory reform for 21st century broadband, Submission to the Department of Broadband, Communications and the Digital Economy, June 2009, p30

<sup>5</sup> Optus, October 2009, Confidential Submission in response to draft determination on Pricing Principles and Indicative Prices for Fixed Line Services, pp.20-24

<sup>6</sup> From \$12.30 in 2005-06 to \$23.60 in 2011-12 (according to the ACCC’s cost model).

### 3. Cost recovery: the asset base

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#### The RAB

*Question 1: whether locking in a value for the RAB, rather than the current approach of continually re-valuing the RAB, would create more certainty for access providers and access seekers, and in turn assist them in making efficient decisions regarding their future investment patterns and general business plans? Why/why not?*

- 3.1 The issue of regulatory certainty was examined by CEG in a June 2009 report, and defined as follows:

*Regulatory certainty requires that parties, both monopolist and access seeker, can predict what prices will be next year and how they are likely to evolve in the long term. This requires knowledge of both: (a) how regulated assets will be valued in the near term; and (b) how the level of compensation over the asset's life will reflect that valuation.<sup>7</sup>*

- 3.2 Under the current regulatory regime, Telstra's network assets are continually revalued at optimised replacement cost.<sup>8</sup> This involves a cost modelling exercise which is subject to numerous uncertainties over parameters and assumptions employed, each of which is typically contentious.<sup>9</sup> There can be a large variation in the resulting access price estimates, even those produced by the same model. The uncertainty is compounded when the existence of competing models is considered.

- 3.3 This approach creates significant variation in asset value resulting in uncertainty over the level of the access price in each regulatory period. As CEG concluded:

*The existing approach under Part XIC re-values existing assets annually (or every few years) using a highly ambiguous methodology for estimating the cost of replacing those assets today. The regime creates significant regulatory uncertainty for access provider and access seekers to the ultimate harm of end users because it provides very little certainty on either (a) or (b) above. The value placed on the*

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<sup>7</sup> CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.2, attached as Attachment 1.

<sup>8</sup> "Under this approach, each time an access price is determined, the existing sunk investment (in this case, the CAN) is revalued on the basis of a hypothetical situation where a brand new network is instantaneously construed, and replicates the existing network's service potential, but uses best-in-use technology based on forecast demand. The 'cost' of building this hypothetical replacement network is therefore the 'asset base' from which access prices are determined." ACCC (2009) *Assessment of Telstra's Unconditioned Local Loop Service Band 2 monthly charge undertaking*, Final Decision, Public Version, April 2009, page 54.

<sup>9</sup> To take just one example, trench sharing has the effect of reducing the cost of trenching that is required when constructing the network. Telstra took the view that trench sharing is unlikely to occur in developed areas and adopted a value of 6.95% whereas the ACCC considered a reasonable range would be 13 to 17%. Other examples include the network technology deployed; the network design; trenching costs; and the value of equipment costs and vendor prices.



*existing assets can change dramatically from one period to another despite the costs actually incurred in building those assets being unchanged. This causes large fluctuations in prices from one period to the next, which are associated with windfall gains and losses to the relevant parties (eg, windfall gains to access providers when prices rise unexpectedly and vice versa). This source of uncertainty over the regulatory price is unnecessary and also counterproductive to any objective of encouraging efficient investment in infrastructure.*<sup>10</sup>

- 3.4 CEG illustrated the problem using an example based on the price of copper, noting that this variable alone could be expected to result in an annual error of around 20%.<sup>11</sup>
- 3.5 Optus submits that locking in a value for the RAB,<sup>12</sup> rather than the current approach of continually re-valuing the RAB, would create more certainty both for the access provider and for access seekers. As CEG concluded:
- The NPV=0 rule could be achieved by locking-in an initial DORC valuation of existing monopoly assets and predictably rolling-forward that value for net capital expenditure. This would significantly increase regulatory certainty for both the access provider and access seekers in contrast to the current regulatory regime.*<sup>13</sup>
- 3.6 Increased certainty would improve the level of comfort of both the access provider and access seekers that they would be able to recover the cost of their sunk investments. For access seekers, these sunk costs include DSLAMs, backhaul fibre and customer acquisition costs.
- 3.7 Consequently, Optus submits that improved certainty would assist all parties to make efficient decisions regarding future investment and general business plans.

**Question 2:** *whether the value of the RAB should be locked in or whether it should continue to be re-valued?*

- 3.8 Despite the conclusion above that lock-in of the RAB would lead to improved certainty which would assist all parties to make efficient investment decisions, alternative arguments may be advanced in favour of revaluation of the RAB.
- 3.9 One such argument (as noted by the ACCC in its discussion paper) is that continual revaluation at optimised replacement cost would generate prices that would provide access seekers with efficient build/buy signals,

<sup>10</sup> CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.2.

<sup>11</sup> CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, pp.22-23

<sup>12</sup> 'Locking in' the RAB would involve establishing an initial asset valuation at the commencement of the regulatory regime (i.e. the 'opening' RAB) and 'roll-forward' that value in the next regulatory period with the objective of achieving NPV=0. Past depreciation of the existing assets will be taken into account in each regulatory period.

<sup>13</sup> CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.2.

whereas locking in a value for the RAB could lead to inefficient duplication of network infrastructure. However, as the ACCC has observed, the cost of replacing the infrastructure that provides fixed line services has been increasing, which suggests that revaluation is unnecessary to prevent inefficient duplication of network infrastructure.

- 3.10 Optus also agrees that it is more efficient for access seekers to provide fixed line services in the retail market by purchasing access services from the existing fixed line network rather than by building their own fixed line infrastructure. This is supported by the Tribunal's reasoning in the HFC exemption case that new infrastructure investment might not be regarded as socially efficient if service provision were available over the existing network at a cheaper cost.<sup>14</sup> Consequently, the 'build-buy' argument in favour of revaluation should be rejected.
- 3.11 Further, revaluation cannot be justified on the grounds of the legitimate business interests of Telstra (which allow Telstra to recover a normal commercial return on its investment) or on the grounds of encouraging investment in the network by Telstra. Revaluation is carried out on the basis of a thought experiment involving a hypothetical, instantaneously constructed new network which is never actually built. This approach is irrelevant to cost recovery: it compensates Telstra for costs it has never incurred nor will incur. As the ACCC itself has recognised, the current approach "*allows for the costs of a replacement asset to be reflected in access prices without requiring that investment in the replacement asset to actually take place*".
- 3.12 Given the flaws in the argument in favour of revaluation, Optus considers that improved certainty is a compelling reason to lock in the value of the RAB. Consequently, Optus submits that the value of the RAB should be locked in rather than to continue to be revalued.

**Question 3:** *whether there are any services for which a pricing approach that locks-in and rolls forward the RAB would not be appropriate? If so, what approach should be taken to pricing these services?*

- 3.13 Arguably, certainty is of most value to access seekers who have incurred significant sunk costs including DSLAMs and backhaul fibre, which might be taken to support a different approach to pricing quasi-infrastructure services (ULLS, LSS) compared to resale services. However all access seekers incur some sunk costs (eg customer acquisition costs). Revaluation-induced fluctuations in prices will thus create some difficulties for all parties.
- 3.14 Further, given there is so little to recommend revaluation, there would be no advantage in revaluing for some services and not for others (even if it were practicable).

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<sup>14</sup> Application by Telstra Corporation Ltd [2009] ACompT 1 (22 May 2009), at [112]

- 3.15 Optus submits that a pricing approach that locks-in and rolls forward the RAB would be appropriate for all services.

### **Defining and measuring an opening RAB**

**Question 4:** *whether a single RAB should be adopted for pricing the ULLS, WLR, PSTN OTA, LSS and LCS services? Why/why not? Which assets should be included in the RAB? Consider the layered nature of telecommunications service provision in your response.*

- 3.16 As the ACCC has correctly observed in its discussion paper, some of the infrastructure used in the production of telecommunications services is common to the production of multiple services, while other elements of the infrastructure are attributable to some services but not others. However, this fact does not require adopting separate RABs for different services. An alternative approach is to allocate infrastructure costs between different services by specifying cost allocation rules, as the ACCC has also observed.
- 3.17 Defining separate RABs for each service merely shifts the burden of cost allocation from one point of the calculation (determining prices for each service from a total allowed revenue) to another point (determining how many assets from total expenditure should be allocated to each service). The ACCC is familiar with the first of these methods, so there is no pressing requirement to introduce an alternative approach.
- 3.18 Moreover, even if separate RABs for different services were adopted, there would remain a need to specify cost allocation rules that govern how the assets in each RAB are allocated to determine prices for the various services. For example, within the CAN it would be necessary to specify a rule to ensure that the cost of pair gain systems were not allocated to ULLS prices (given that lines with pair gain systems cannot be used to supply the ULLS). Even if many RABs are created to cater for all the different asset types to avoid this problem, a cost allocation methodology will nevertheless be required to the extent that one asset type is used by more than one service. For example, the Telstra duct network is not specific to any single service.
- 3.19 Optus submits that a single RAB should be adopted for pricing the ULLS, WLR, PSTN OTA, LSS and LCS services. It is appropriate to treat the RAB as a financial concept which exists in order to ensure FCM. Recovery based on the single asset base can be allocated between different services in a rational and consistent manner, without the need to define separate RABs for separate services.

**Question 5:** *whether there should be different RABs for different fixed line services? Why/why not? If so, which assets should and should not be included in the different RABs for each service? Consider the layered nature of telecommunications service provision in your response.*

- 3.20 It is not necessary or appropriate to define a separate RAB for each individual fixed line service, as discussed under question 4 above.

**Question 6:** *how should past compensation to the access provider (i.e. past depreciation) be taken into account in setting an opening RAB?*

- 3.21 This question requires consideration of the access provider's "legitimate business interests", which is a reference to "the interest of a carrier in recovering the costs of its infrastructure and its operating costs and obtaining a normal return on its capital".<sup>15</sup> This refers to the carrier being able to recover its actual investment. As the Tribunal has recognised, the access provider's "legitimate business interests" do not extend to extracting monopoly rent for the CAN or receiving a price that reflects the value of the CAN derived from its natural monopoly characteristics. It follows that it is not in a carrier's legitimate business interests to make an above-normal return on its investment.
- 3.22 As the ACCC has recognised in its discussion paper,<sup>16</sup> in order to ensure that the access provider is not over- or under-compensated over the long-term, past compensation would need to be taken into account in setting an opening RAB. This is consistent with asset valuation requirements imposed in other sectors, for example, section 8.10(f) of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the **Gas Code**) required the ACCC, when setting an initial capital base, to have regard to: "*the basis of which Tariffs have been (or appear to have been) set in the past, the economic depreciation of the Covered Pipeline, and the historical returns to the Service Provider from the Covered Pipeline.*"
- 3.23 This requirement recognises that past recovery of capital investment through tariffs and charges is highly relevant to the selection of an appropriate asset valuation methodology.<sup>17</sup> Optus submits that a similar approach is required to the valuation of fixed line telecommunications network assets. If the opening RAB were set above Telstra's residual costs, end-users would be paying a second time for the depreciation allowance of a portion of the assets, delivering a windfall gain to the access provider. Optus submits that the opening RAB should be set in such a way that Telstra does not make windfall gains.

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15 Telstra Corporation Limited [2006] ACompT 4 at [89] (referred to with approval in Re Telstra Corporation Ltd (No 3) [2007] ACompT 3 at [180]).

16 ACCC, *Review of 1997 Guide to telecommunications access pricing principles for fixed line services*, Discussion Paper, December 2009, p.35

17 Re Application by East Australian Pipeline Limited [2004] ACompT 8 at [19], [29].

3.24 A significant period of time has elapsed since the construction of much of the CAN, and most of the relevant network assets have been written down significantly over that period. Whilst a proportion of the CAN was constructed inside the last two decades, it is clear from historical records that a very high proportion of the CAN is much older. This is supported by public statements from Telstra. For example, in 2001 Telstra reported the following information on the age of the CAN:

*“...more than 50 per cent of the copper pairs in the Australian CAN are over 20 years old, more than 30 per cent are over 30 years old and nearly 10 per cent predate 1950”.*<sup>18</sup>

3.25 It follows that Telstra is likely to have recovered much of the cost of the network over that period through its retail and wholesale revenues.<sup>19</sup>

3.26 Valuation of Telstra’s assets at replacement cost ignores the previous recovery of Telstra’s investment. Such a measure compensates Telstra as if it is constructing a “brand new” network, today. This allows Telstra to recover a level of costs that must exceed costs it actually incurred historically, given the age and economic lifetimes of the relevant CAN assets. In fact this approach enables Telstra to recoup a return on network investments it never made.

3.27 The ACCC has recognised the problem of double recovery arising where no discount is allowed for past depreciation of existing assets.<sup>20</sup> The double recovery issue which arises with optimised replacement cost pricing approaches has also been recognised in other jurisdictions.<sup>21</sup>

3.28 Further, taking into account past compensation would neither impair incentives for Telstra to incur costs of supply efficiently going forward nor discourage investment in regulated fixed line network infrastructure over the long term (given that Telstra is assured of recovering its costs, including a normal commercial return).

3.29 Optus submits that past compensation received by Telstra should be taken into account in setting its opening RAB. To the extent that net compensation (after the operating and maintenance costs of the network assets have been taken into account) has been in excess of a normal commercial return on investment, it should be treated as a return of capital to Telstra (i.e. past depreciation). That portion of the capital investment which has already been returned to investors no longer attracts a return on investment and no longer forms part of the regulated asset base.

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18 Telstra, *Productivity Commission’s draft report on Telecommunications Competition Regulation – Final Submission*, July 2001, p.21

19 The ACCC has noted that a proposed charge of \$30 would allow Telstra to over recover its costs. Considering 50% of Telstra’s network has already been depreciated, Optus has a strong belief that an access charge of \$23.60 would also allow Telstra to over recover its costs of providing the regulated service.

20 ACCC, *Assessment of Telstra’s ULLS Band 2 monthly charge undertaking*, Final Decision, April 2009, pp.54-55

21 Europe Economics, *Pricing Methodologies for Unbundled Access to the Local Loop*, Final Report, May 2004, p 48

**Question 7:** *which approach to valuing sunk assets should be used in setting an opening RAB?*

- 3.30 The ACCC has identified a number of alternative approaches to valuing sunk assets which should be used in setting an opening RAB, including:
- historic cost/actual cost;
  - depreciated historic/actual cost (DHC/DAC);
  - current replacement cost;
  - optimised replacement cost (ORC); and
  - depreciated optimised replacement cost (DORC/ODRC).<sup>22</sup>
- 3.31 The three approaches which have been advanced as serious candidates for an asset valuation methodology are ORC, DAC and DORC. Each of these three approaches is examined in turn below.

*Optimised replacement cost (ORC)*

- 3.32 The current approach to compensating Telstra utilises the ORC method of asset valuation, which involves valuing network assets at the cost of replacement with modern equivalent assets, without making any allowance for the age or condition of the actual network. ORC requires the use of a cost model which designs a hypothetical optimised network.
- 3.33 Optus considers that ORC does not generate prices that are equivalent for all access seekers (including the access provider's downstream arm). This is because access prices reflecting the replacement cost of the CAN would provide Telstra with a significant revenue source surplus to its actual requirements,<sup>23</sup> and force access seekers to face an access cost significantly higher than the costs faced by Telstra's retail operation (that is, the cost Telstra would require from its own downstream operations in order to remain viable). It follows that alternative valuation methods which take past compensation into account in setting the initial RAB will allow access seekers to compete on a level playing field with Telstra.<sup>24</sup>
- 3.34 It is sometimes argued that it is necessary to value assets at optimised replacement cost (and ignore past compensation) in order to provide access seekers with efficient build/buy signals. This argument is wrong as it is based upon an incorrect understanding of the relevant costs; its

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<sup>22</sup> ACCC, *Review of 1997 Guide to telecommunications access pricing principles for fixed line services*, Discussion Paper, December 2009 p25

<sup>23</sup> Due to the imminent construction of the NBN, the CAN will not be required in the long run and it will not be efficient for Telstra to make further significant infrastructure investments in the CAN and nor is it at all likely that it will do so. It follows that Telstra will not need to recover revenue reflecting the replacement cost of the CAN from supplying services to its own downstream operations in order to remain viable.

<sup>24</sup> Access prices reflecting the replacement cost of the CAN would not permit access seekers to bring their relative efficiencies to bear upon the retailing and other remaining stages of the production process and would undermine competitive neutrality.

flaws were identified as early as 2003 in a NERA report (attached to this submission as Attachment 4).<sup>25</sup> The deficiencies in relying on models which estimate the replacement cost of a copper network to send efficient build/buy signals were also exposed in an expert report of Henry Ergas (commissioned by Telstra). Ergas noted that:

*“From society’s perspective, entry is efficient if it leads to lower costs than would otherwise be incurred. In my opinion, this does not depend on the costs that would be incurred in a hypothetical replication of the existing network on a fully efficient basis, but on the costs that are actually going to be incurred. As a result, in my opinion, purely hypothetical costs (such as those generated by a TSLRIC model), regardless of the depreciation profile adopted, will not provide the socially correct signal for competing entry to the extent that they do not reflect the costs society actually incurs when service is provided by the access provider rather than by the access seeker. Even setting that aside, from an analytical perspective, it is contentious whether the choice of cost standard has an effect on entry decisions. Finally, it seems highly unlikely than any actual entry would take the form of replicating Telstra’s copper pair network, regardless of how depreciation for that network was calculated.”<sup>26</sup> (references and footnotes omitted)*

- 3.35 Moreover, the ‘build/buy signals’ argument in favour of replacement cost is premised on the incorrect assumption that it is likely to be efficient to encourage access seekers to duplicate Telstra’s network infrastructure. As the ACCC observed in its discussion paper, it is likely to be more efficient for access seekers to provide fixed line services in the retail market by purchasing access services from the existing fixed line network rather than by building their own fixed line infrastructure. This is supported by the Tribunal’s reasoning in the HFC exemption case that new infrastructure investment might not be regarded as socially efficient if service provision were available over the existing network at a cheaper cost.<sup>27</sup> Optus submits the ACCC should reject any argument in favour of replacement cost pricing which is based on encouraging access seekers to build new infrastructure.
- 3.36 Optus submits that replacement cost-based prices create a significant risk of encouraging inefficient bypass of the fixed line network, discouraging the efficient use of existing infrastructure. By contrast, alternative methods that take into account past compensation would discourage such inefficient duplication and encourage efficient use of the CAN.
- 3.37 For the reasons discussed above under question 6, Optus considers that past compensation to Telstra should be taken into account in setting its

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25 NERA found that there is a range of costs consistent with efficient investment incentives, and the ACCC’s current approach to asset valuation results in values above the upper bound of that range. The ‘efficient upper bound’ for the asset value (and the associated access price) is given by the quality-adjusted average cost of a new entrant. NERA, Role of TSLRIC in telecommunications regulation, July 2003 (attached as Attachment 4)

26 Concept Economics, *Depreciation* – Prepared for Mallesons Stephen Jacques, August 2008, pp 51-52

27 *Application by Telstra Corporation Ltd* [2009] ACompT 1 (22 May 2009), at [112]

opening RAB. Accordingly, optimised replacement cost is inappropriate for setting Telstra's opening RAB since it does not take past compensation into account. The same criticism applies to historic cost/actual cost and current replacement cost. Applying any of these methods would allow Telstra to recover the cost of its sunk assets twice over. These methods are not considered further.

- 3.38 By contrast, depreciated historic/actual cost (DHC/DAC) and depreciated optimised replacement cost (DORC/ODRC) are potentially appropriate approaches since both methods make an adjustment which may be considered a reasonable way to account for past compensation. Both DAC and DORC are considered reasonable in the energy sector, where the initial capital base of an existing gas pipeline "*normally should not fall outside the range of values determined under paragraphs (a) and (b) of section 8.10.*"<sup>28</sup>
- 3.39 DORC and DAC are examined in more detail in the following sections.

#### *Depreciated actual cost (DAC)*

- 3.40 The historic (or actual) cost of an asset can be defined as the original cost of acquisition or rollout of an asset. The depreciated actual cost (DAC) is the value of the historic cost of the asset *adjusted* for the proportion of costs that have been recovered (past compensation).
- 3.41 In order to determine the appropriate adjustment to the historic cost of the asset, information may be required on Telstra's costs and on the amount of those costs that have been recovered in the past (i.e. past depreciation), as the ACCC has recognised in its discussion paper.
- 3.42 In determining DAC, one approach is to take as the starting point the cost of construction of the asset. Alternatively, given that the intention is to ensure that investors receive a normal commercial return on their investment, it may be appropriate to focus on cost recovery from the point of view of investors. This might involve estimating the value that it would have been reasonable for investors to ascribe to the assets on privatisation as the starting point.
- 3.43 In either case the next step is to estimate the extent of cost recovery that has occurred to date. To the extent that net compensation (after the operating and maintenance costs of Telstra's fixed network assets have been taken into account) has been in excess of a normal commercial return on investment, it should be treated as a return *of* capital to Telstra (i.e. past depreciation).
- 3.44 It is possible to estimate the level of net compensation received by Telstra based upon publicly available data. CEG has carried out modelling in order to estimate the level of net compensation received by Telstra since privatisation. This modelling resulted in values for Telstra's CAN today in the order of \$8 billion. CEG's results are set out in the report attached

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<sup>28</sup> Gas Code, section 8.11.



as Attachment 2.<sup>29</sup> CEG's modelling demonstrates Telstra has over recovered its costs by approximately \$4.5 billion due to repeated revaluation of network assets at optimised replacement cost under the current regime.<sup>30</sup> Further, if the opening value of Telstra's RAB in 2010 were calculated according to optimised replacement cost (assume a value of \$35 billion), this would allow Telstra to lock in over recovery of approximately \$27 billion.

3.45 An alternative approach is to estimate the extent of cost recovery based on the regulated entity's accounting records. The book value of an asset may be treated as a reasonable approximation of its DAC. For example, the ACCC has noted that "[t]he *Western Australia Full Court in Re Michael* observed that in calculating the DAC it is usual to take the net book value and to depreciate this in line with accounting standards."<sup>31</sup>

3.46 Similarly, in the *Roma to Brisbane Pipeline* inquiry the ACCC rejected the use of economic depreciation. Noting that sufficient financial information was available to establish the value of DAC using the book value, it concluded that:

*"[t]he ACCC did not accept APTPPL's argument that DAC has to be applied using economic depreciation."*<sup>32</sup>

*"[t]he ACCC maintains its position that DAC should be calculated using accounting depreciation."*<sup>33</sup>

3.47 The depreciated historic cost (written down value) of Telstra's network as reported in its regulatory accounts is approximately \$8 billion.<sup>34</sup> CEG has made adjustments to this value to account for changes in the price level and subsequent cost recovery. This resulted in values for Telstra's CAN today of between \$2 billion and \$6 billion. CEG's results are set out in the report attached as Attachment 2.<sup>35</sup>

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29 CEG, 2010, *Past cost recovery and asset valuation*, (attached as Attachment 2)

30 Compared to a counterfactual where a RAB roll-forward approach had been adopted since 1997.

31 *Re Dr Ken Michael AM; ex parte EPIC Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231, para 163 cited in ACCC, *Revised access arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline*, Final Decision, December 2006, p.17

32 ACCC, *Revised access arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline*, Final Decision, December 2006, p.18

33 ACCC, *Revised access arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline*, Final Decision, December 2006, p.45

34 ACCC, *Assessment of Proposals: National Broadband Network Process, Report to Expert Panel*, Appendices, Confidential Version, January 2009, Appendix B, p.59, in ACCC, *National Broadband Network: regulatory reform for 21st Century broadband*, Submission to the Department of Broadband, Communications and the Digital Economy, June 2009

35 CEG, 2010, *Past cost recovery and asset valuation*, (attached as Attachment 2)

## DORC

- 3.48 An alternative approach to valuing network assets is the Depreciated Optimised Replacement Cost (DORC) method. The calculation of a DORC value has been described by CEG as follows.

*“DORC is calculated as the cost of replacing the existing network with one that is optimally configured at current day prices less an assessment of depreciation. The level of depreciation depends on the remaining life of existing assets and differences in service quality.”*<sup>36</sup>

- 3.49 The ACCC has described the DORC of an asset in the following terms:

*“Another justification for DORC setting the upper limit to valuations comes from what a DORC valuation actually is attempting to measure. This is the maximum price that a firm would be prepared to pay for ‘second hand’ assets with their remaining service potential, higher operating costs, and (old) technology given the alternative of installing new assets which embody the latest technology, generally have lower operating costs, and which will have a greater remaining service potential.”*<sup>37</sup>

- 3.50 CEG has carried out modelling in order to estimate two alternative DORC valuations of Telstra’s assets (one based upon a 1997 ORC valuation and another based upon a 2009 ORC valuation). This modelling resulted in values for Telstra’s CAN today of approximately \$8 billion for the 1997 DORC valuation and between \$11 billion and \$16 billion for the 2009 DORC valuation.

## Comparing DORC and DAC

- 3.51 Valuation methodologies which take account of past compensation received by Telstra are likely to be consistent with the legislative criteria, as discussed above under question 6. The depreciation adjustment made in calculating a DORC – which depends upon the remaining life of existing assets and service quality – is not strictly speaking intended to calculate the level of past compensation received by the access provider. Nevertheless the level of the adjustment will vary with the age of the assets, that is the length of time available for Telstra to have earned revenue from the assets. Hence it may be treated as a reasonable approximation of the level of the economic value of the asset that has been recovered through past compensation received by Telstra.
- 3.52 Moreover, DORC is considered to have inherent properties consistent with a proper balancing of the interests of both investors and access seekers. Optus notes CEG’s view that by *“putting a ‘fair’ value on the asset given its remaining life and service potential relative to a*

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<sup>36</sup> CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.11

<sup>37</sup> ACCC, *Final Decision Access Arrangement by Transmission Pipelines Australia Pty Ltd and Transmission Pipelines Australia (Assets) Pty Ltd for the Principal Transmission System (and related pipelines)*, 6 October 1998, CR97/159

*replacement network it serves to protect the legitimate business interests of the monopoly*<sup>38</sup> access provider (by providing a fair market value), and that a “*DORC estimate will fall within [the efficient] range being above scrap value but below the full replacement cost (assuming assets have some remaining life).*”<sup>39</sup> By putting a ‘fair’ value on the asset given its remaining life and service potential relative to a replacement network the use of DORC serves to promote competitive neutrality, and it “will also promote entry by access seekers (reducing the risk of sunk cost expropriation) thereby promoting competition”<sup>40</sup> and that by “putting a ‘fair’ value on the asset given its remaining life and service potential relative to a replacement network it serves to protect [...] the interest of access seekers (in not overpaying for an old asset).”<sup>41</sup>

- 3.53 As CEG states in the paper attached as Attachment 1, DORC “...*has strong economic foundations and regulatory precedent as a basis for determining the value of regulatory assets and is consistent with the economic principles which underpin Part XIC*”.<sup>42</sup>
- 3.54 DORC is a recognised method, and has been used by regulators in the UK,<sup>43</sup> as well as in Australia.
- 3.55 Nevertheless, there are also practical considerations in choosing a valuation methodology. Relative to DAC, the DORC method may be considered to have some practical disadvantages. For example it may be considered:
- informationally and conceptually more complex;
  - subject to a higher degree of uncertainty surrounding the estimation of parameter values;
  - more prone to modelling error; and / or
  - more dependent upon use of information that is asymmetrically held by an interested party (i.e., the regulated business).
- 3.56 The ACCC considered that these practical considerations were relevant to the choice of valuation methodology in its inquiry on the *Roma to Brisbane Pipeline*.<sup>44</sup> The regulator has also expressed similar reservations in the electricity context:

*“The Commission considers that a well defined DORC approach has some significant advantages as a cap to asset valuation from the*

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38 CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.39

39 CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.39

40 CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.39

41 CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.39

42 CEG, *Reform of Part XIC: Regulatory Certainty*, June 2009, p.3

43 OFFGAR, *Draft decision: Proposed access arrangement – Dampier to Bunbury Natural Gas Pipeline*, Draft Decision, Part B, June 2001, pp.145

44 ACCC, *Revised access arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline*, Draft Decision, August 2006, p.32 (quoting NERA, *Comparison of DORC estimation procedures*, A report for the ACCC, 25 July 2006)

*viewpoint of economic efficiency. The Commission notes the criticisms to the effect that it is a less auditable value than DAC, and that it may overvalue assets or re-value assets that have already been fully depreciated.”*<sup>45</sup>

- 3.57 A similar conclusion was reached in the case of Sydney Airport, which proposed to use DORC to value its assets, the ACCC noted that:

*“Given the difficulties of deriving a valuation based on opportunity cost, the Commission accepted advice from independent consultants to use the historic cost of the site indexed by CPI. Historic cost has the advantage that it is readily identifiable and less subjective than the principles proposed by Sydney Airport. It provides compensation to the owner of Sydney Airport for investments into land already undertaken. It also provides incentives for the airport operator to acquire additional land.”*<sup>46</sup> [emphasis added]

- 3.58 Practical considerations such as those noted above may be considered to favour a valuation based upon DAC, which is a simple and transparent method which does not involve complex models of efficient network design. Further, the regulator needs more than a range of possible values: it must choose a particular asset value. The written down audited book value of Telstra’s network assets provides such a value, calculated in accordance with generally accepted accounting principles.
- 3.59 The written down book value of Telstra’s network assets is likely to be consistent with cost recovery by Telstra. In this regard, Optus notes the ACCC’s view that the “*backward looking perspective (historic/actual costs) provides more certainty with regard to investment cost recovery...*”<sup>47</sup>
- 3.60 This approach is also consistent with international best practice in valuation of fixed line network assets. Ofcom has found that valuation of BT’s network assets according to the written down book value of BT’s assets was appropriate. As the ACCC noted in its discussion paper, in 2005, Ofcom split BT’s asset base into a pre- and post-1997 asset base to prevent further over-recovery on pre-1997 assets as a result of upward revaluation. The regulatory asset value for BT’s pre-1997 assets was set equal to the closing historical cost accounting value for those assets in the 2004-05 financial year.<sup>48</sup> Further, US regulators have historically relied upon historical cost valuations of assets as a basis for rate-of-return regulation.<sup>49</sup>

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45 ACCC, *Draft statement of principles for the regulation of electricity transmission revenues*, May 1999, p.48

46 ACCC, “ACCC Airports and Aviation – Regulatory and competition issues,” Professor Allan Fels, ACCC Chairman, Speech to Airports and Aviation Outlook 2001 Conference, 21 November 2001, p.6

47 ACCC, *Assessment of Proposals – national broadband network process*, A report to Expert Panel, Appendices, Public Version, January 2009, p.64 cited in ACCC, *National broadband network: Regulatory reform for 21st century broadband*, Submission to the Department of Broadband, Communications and the Digital Economy, June 2009

48 Ofcom, *Valuing Copper Access* — Final Statement, 2005

49 OFFGAR, *Draft decision: Proposed access arrangement – Dampier to Bunbury Natural Gas Pipeline*, Draft Decision, Part B, June 2001, pp.145

### *Conclusion on valuation of sunk assets*

- 3.61 Optus submits that the ACCC should value Telstra's sunk assets according to the DAC methodology, using the written down book value, since it is a method which is simple and transparent and results in values that are consistent with cost recovery, fairness to investors and the other legislative criteria.

**Question 8:** *whether the same approach should be applied to all asset categories, or whether different approaches should be applied to different asset categories (e.g. ducts and pipes versus electronics)?*

- 3.62 It is unnecessary to make explicit distinctions between the approaches used to value different categories of network assets. The legislative criteria will be achieved by valuing all network assets in a manner consistent with cost recovery.
- 3.63 A decision to value some asset category in Telstra's network at replacement cost instead of depreciated actual cost would achieve little. Critically, it would not encourage Telstra to replace assets in that category in a more efficient or timely manner, since there is no link between the valuation and actual replacement. (Telstra could be encouraged to replace assets in a timely manner by compensating it when it actually incurs capex, as discussed later in this paper.)
- 3.64 Further, it could not assist access seekers to make an efficient build/buy decision, since (even if it were efficient to encourage duplication of access networks, which it is not) access seekers are not able to choose to bypass Telstra's network on a category by category basis (build/buy is an all-or-nothing decision for an access seeker).
- 3.65 Valuing CAN assets on different methodologies would create a disassociation between costs incurred and cost recovery, and possibly lead to overcompensation (cost recovery in excess of capital invested).
- 3.66 Optus submits that there is nothing to be gained by departing from cost recovery for some types of network assets.
- 3.67 However, land and easements may require special consideration. It is recognised that easements do not wear out and have no alternative use, and there is no real market for easements, many of which are acquired under compulsory acquisition, making valuation particularly difficult and prone to error. The use of a valuation which reflected escalating property values (such as ORC) would cause the value of easements to appreciate more rapidly than CPI, providing windfall gains to the service provider and price shocks for consumers. Optus considers that easements should be incorporated into the RAB at historic cost. Further, Optus submits that Telstra's RAB should be adjusted downwards to account for past cost recovery (and opportunities for future cost recovery) resulting from the sale of property at significant profit over the original purchase cost.

**Question 9:** *if a DORC valuation were to be adopted, which approach to constructing DORC should be used?*

- 3.68 Arguably, the NPV approach to DORC could lead to a cost recovery result which approaches fairness to investors.
- 3.69 However relative to straight-line DORC, the NPV DORC method may be considered to have some practical disadvantages. For example it may be considered:
- informationally and conceptually more complex;
  - subject to a higher degree of uncertainty surrounding the estimation of parameter values;
  - more prone to modelling error; and / or
  - more dependent upon use of information that is asymmetrically held by an interested party (i.e., the regulated business).
- 3.70 These practical considerations may be considered to favour a valuation based upon straight-line DORC, which is a relatively simple and transparent method. The ACCC found, based upon these considerations, that straight-line DORC was an appropriate valuation methodology in its inquiry on the *Roma to Brisbane Pipeline*.<sup>50</sup>

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<sup>50</sup> ACCC, *Revised access arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline*, Draft Decision, August 2006, p.32 (quoting NERA, *Comparison of DORC estimation procedures*, A report for the ACCC, 25 July 2006)

## 4. Ongoing cost recovery

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### The NBN

- 4.1 In setting the path of access prices over time, the costs of sunk investments should be allocated in such a way that Telstra is able to recover the outstanding value of capital invested (the RAB), avoiding both over- and under-compensation. Other objectives in choosing the path of depreciation and access prices include efficiency over time, business certainty and avoidance of rate shock.
- 4.2 The ACCC's task of choosing an appropriate path for depreciation and access prices has been made significantly more complex by the Government's deployment of a National Broadband Network (NBN) over the next eight years. The NBN is intended to deliver a wholesale-only, open access telecommunications market structure, and involves fibre to the premises technology for the majority of premises.<sup>51</sup>
- 4.3 The Government has formed a company (NBNC<sub>o</sub>) to deploy the network within the eight year timeframe and announced the appointment of numerous employees, including Mike Quigley as the Executive Chairman and CEO of the NBNC<sub>o</sub> and a Board of Directors. NBNC<sub>o</sub> has since initiated a number of key projects, including:
- launch of the Tasmanian NBNC<sub>o</sub> subsidiary;<sup>52</sup>
  - regional backhaul tender;<sup>53</sup>
  - industry consultation beginning in December 2009 with release of NBNC<sub>o</sub>'s proposed product plans for the NBN;
  - draft legislation (released on 24 February 2010) on access regime and ownership and governance arrangements.<sup>54</sup>
- 4.4 In order to minimise construction costs, NBNC<sub>o</sub> is likely to need access to existing infrastructure, particularly Telstra's nationwide network of

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51 DBCDE in its NBN policy paper notes that "Fibre optic to the home and workplace technology (or FTTP) is the state of the art 'future proof' fixed broadband technology and is capable of providing customers with download speeds of 100 Mbps and upload speeds of 50 Mbps." (DBCDE, *21st Century Broadband*, Policy Brochure, April 2009, p.4) This is comparable to the current maximum achievable access speeds of up to 20Mbps offered on Telstra's ADSL 2+ network.

52 This subsidiary is responsible for the Tasmanian NBN rollout which commenced in August 2009, targeting 5,000 initial premises in 3 towns for targeted turn on of services in July 2010. The first trench has already been dug and the first cable is expected to be delivered by the end of October 2009.

53 On 5 August 2009, tenders were lodged by a range of parties including Optus for a \$250 million government build of new regional backhaul fibre network, with the ambition to commence construction early 2010. The tender was awarded to Nextgen Networks in December 2009, with work on the backhaul link beginning in Queensland in February 2010.

54 Australian IT, "NBN Co draft legislation unveiled," 24 February 2010, <http://www.theaustralian.com.au/australian-it/nbn-co-draft-legislation-unveiled/story-e6frgax-1225833830996>

trenches and ducts, to deploy its FTTP infrastructure. This is consistent with the view expressed in the Third Report of the Senate Committee:

*“The obvious solution would be to utilise as much of Telstra's existing infrastructure – its underground conduits, pits and pipes – as possible. The value placed on Telstra's assets, and consequently the bargaining power it could wield, was also subject to much industry speculation”*<sup>55</sup>

- 4.5 In order to be commercially successful, NBNCo must carry the bulk of national traffic. That is, it requires Telstra's retail customers to be served across its network infrastructure. This view is held by industry analysts. For example Morgan Stanley's view is that:

### **CiC begins**

### **CiC ends**

- 4.6 This is also consistent with the view expressed in the Third Report of the Senate Committee:

*“With the view that market penetration rates of around 60 to 70 per cent will be required for the NBN Co to be commercially viable, the obvious question is how can that be achieved by a new network when the current incumbent, Telstra, will also be striving to retain at least 60 per cent of the market.”*<sup>56</sup>

- 4.7 It has been publicly reported that NBNCo is negotiating with Telstra in order to secure an agreement that Telstra will:
- (1) provide access to its passive infrastructure (such as trenches and ducts) to reduce duplication of infrastructure; and
  - (2) ‘switch off’ its legacy network and migrate its retail customers across to the NBN.
- 4.8 On 18 December 2009, NBNCo and Telstra announced they had formalised the Terms of Engagement –which includes a preferred model that involves the progressive transition from Telstra's copper access network to a FTTP NBN and an acceptable solution for the use of passive infrastructure.<sup>57</sup>
- 4.9 Telstra appears to be actively participating in these negotiations,<sup>58</sup> signalling it is *“negotiating in good faith to reach such an outcome.”*<sup>59</sup>

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55 The Senate, *Senate Committee on the National Broadband Network – Third Report*, November 2009, p.84

56 The Senate, *Senate Committee on the National Broadband Network – Third Report*, November 2009, p.84

57 Minister for Broadband, Communications and the Digital Economy, “Terms of Engagement agreed between Telstra and NBN Co,” Media Release, 18 December 2009

58 Telstra, “Telstra formalises Terms of Engagement with NBN Co,” Media Release, 18 December 2009



The Terms of Engagement highlights progress in the talks between the two parties on Telstra's NBN participation.<sup>60</sup>

- 4.10 In order to secure Telstra's agreement to the two points above, NBNC Co is expected to pay Telstra a large sum in consideration, including an ongoing stream of rental payments for ongoing use of duct and trench infrastructure. The consideration received by Telstra from NBNC Co may run into billions of dollars. There remains a clear risk that NBNC Co may overpay to secure Telstra's cooperation.
- 4.11 Optus considers that a number of conclusions should be drawn from these facts. First, the NBN should not be regarded as an 'infrastructure based competitor' to Telstra. It is clear from the above that NBNC Co will not compete against Telstra. As the NBNC Co has stated, "*continuing to invest in maintaining older infrastructure when a new fibre network is available would not produce the best outcome for telecommunications retailers and consumers.*"<sup>61</sup> Instead, NBNC Co will cannibalise elements of Telstra's network in deploying its own network, and will serve Telstra's retail customers across its own network infrastructure.
- 4.12 Second, the NBN will not prevent Telstra from recovering the outstanding costs of its sunk investments. To the contrary, Telstra will extract a significant sum from NBNC Co which is likely to more than compensate it for those outstanding costs. The label given to that payment by NBNC Co and / or Telstra is immaterial; the substance of the deal must be considered. The substance is that Telstra will be compensated for the fact that it will no longer be able to earn revenue through the use of its own network in the future (since it will have 'switched off' that network and given away the use of a proportion of the network assets).
- 4.13 Optus submits that the ACCC should recognise that there is an alternative form of compensation and cost recovery for Telstra (other than retail revenue and wholesale access revenue). If a deal is in place before the ACCC finalises access prices, then it would be appropriate to take into account the entirety of the consideration Telstra receives from its deal with NBNC Co for the purposes of considering whether Telstra as recovered the outstanding costs of its sunk investments.

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59 Telstra, "Analysing Telstra's impending separation: the options," David Quilty, GMD, Public Policy & Communications, Speech, 7 December 2009

60 Minister for Broadband, Communications and the Digital Economy, "Terms of Engagement agreed between Telstra and NBN Co," Media Release, 18 December 2009

61 NBN Co Limited, "Negotiations between NBN Co and Telstra," Media Release, 18 December 2009

## Depreciation

*Question 10: the path of access prices over time that should be adopted — interested parties should consider whether cost-recovery should be front loaded (suggesting that the path of access prices over time will fall), back loaded (suggesting the path of access prices over time will rise) or in equal amounts in each regulatory period.*

- 4.14 In considering whether cost-recovery should be front loaded, back loaded or in equal amounts in each regulatory period, the ACCC has noted that the prospects for future infrastructure based competition should be considered, since it might reduce the operator's ability to recover costs in later years. It has noted that if the costs of replacing the infrastructure are falling, there may be an argument for applying a depreciation schedule that allows more cost recovery in the earlier years of an asset's life.
- 4.15 Optus submits that this argument does not apply. The costs of replacing infrastructure are likely to be rising in line with labour costs. As the ACCC has recognised, "the cost of replacing the infrastructure has been rising".<sup>62</sup>
- 4.16 More importantly, however, given the facts about the NBN discussed above, there is no need to hypothesise about what shape future network infrastructure might take, whether it will compete with Telstra, what it will cost and what impact it will have upon Telstra's cost recovery. The discussion should focus squarely upon the NBN and the compensation payment NBNC<sub>o</sub> will make to Telstra.
- 4.17 Telstra therefore does not face a risk of future infrastructure based competition. The NBN is unlikely to be rolled out in mainland Australia until NBNC<sub>o</sub> and Telstra reach agreement on the terms of transition from Telstra's network to the NBN. And while on one view Telstra's ability to use its network to recover costs in later years might be impacted by the NBN, there can be no doubt that Telstra will be compensated for that impact (albeit the exact size of the payout is not yet known).
- 4.18 It follows that there is no justification for applying a frontloaded depreciation schedule that allows Telstra more cost recovery in the earlier years of the new regime.
- 4.19 On the other hand, there is an argument that the depreciation schedule should be back loaded. As noted above, the payout by NBNC<sub>o</sub> to Telstra will be very significant. The payout may include both an upfront payout and an ongoing rental, and it may be labelled as a payment for Telstra's traffic and/or for its assets. The price Telstra receives may well exceed the remaining unrecovered value of its network assets. If this is the case, then if depreciation were frontloaded or flat, Telstra would over-recover. The prudent course of action for the ACCC given this very real risk of

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<sup>62</sup> ACCC, *Review of 1997 Guide to telecommunications access pricing principles for fixed line services*, Discussion Paper, December 2009, p.30

over-recovery may be to back load cost recovery, and this approach should be considered.

- 4.20 As the ACCC has correctly stated, the choice of the approach to depreciation is essentially a question of how the costs of sunk investments should be allocated over time, and in turn, what the desired path of access prices over time should be. Given the inapplicability of infrastructure competition issues discussed above,<sup>63</sup> and given that the approach to depreciation is discretionary, Optus considers that the profile of cost recovery should in general be subordinate to the choice of an appropriate price path (subject to the issues related to the NBN and Telstra's negotiations with NBNC<sub>o</sub> as discussed above and below<sup>64</sup>).
- 4.21 Optus considers that a flat path for access prices (neither rising nor falling over time) would generally be appropriate, in order to facilitate certainty for business purposes.

***Question 11: which approach to depreciation should subsequently be adopted?***

- 4.22 Optus has recommended that the ACCC adopt an approach to the opening RAB which values existing assets by taking into account the past compensation received on the assets. Going forward, Optus recommends an approach whereby these existing assets gradually 'unwind' from the RAB as they are depreciated, and future replacement capital expenditure is rolled into the RAB at its actual cost as it occurs.
- 4.23 As noted above, Optus considers that the approach to depreciation should in general be subordinate to the choice of an appropriate price path (subject to the issues related to the NBN and Telstra's negotiations with NBNC<sub>o</sub> as discussed above and below<sup>65</sup>). Optus submits that depreciation should be structured in order to set access prices which follow a flat path, subject to the need for an initial transition period as discussed under questions 32 and 33 below.
- 4.24 Turning to the impact of the NBN, if a deal between Telstra and NBNC<sub>o</sub> is in place before the ACCC finalises access prices, then the ACCC should take into account the entirety of the consideration Telstra receives from its deal with NBNC<sub>o</sub> for the purposes of considering whether Telstra has recovered the outstanding costs of its sunk investments. The initial capital value of the RAB should be reduced to take into account all consideration received by Telstra from NBNC<sub>o</sub>.

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63 Given the inapplicability of the infrastructure competition issues discussed above, a front loaded depreciation profile would be unnecessary and inappropriate.

64 As noted above, the ACCC may wish to consider whether to apply a back loaded cost recovery profile, in order to address any possible over-recovery by Telstra which result from its deal with NBNC<sub>o</sub>.

65 As noted above, the ACCC may wish to consider whether to apply a back loaded cost recovery profile, in order to address any possible over-recovery by Telstra which result from its deal with NBNC<sub>o</sub>.

- 4.25 If no deal between Telstra and NBNCo is in place before the ACCC finalises access prices, then the ACCC should not set access prices based upon speculation about what shape a final deal might take. However, the ACCC should plan to take into account the deal (in the manner described above) once it becomes agreed and the salient information (the assets involved, the traffic migration aspect, the consideration, the agreed shut-down date of the copper network) is known.
- 4.26 The ACCC should stand ready to adjust its regulatory settings in order to prevent over-recovery, through adjustments to the RAB and through adjustments to the ongoing depreciation component of access charges. If Telstra agrees to shut down its network and migrate its customers to the NBN, then its RAB should be adjusted immediately to take account of any payments made by NBNCo to Telstra in exchange for:
- i) shutting down its network and migrating its customers to NBNCo; and / or
  - ii) purchase / access to Telstra's network assets (eg ducts);
- 4.27 Any final payment which NBNCo agrees to make to Telstra upon completion of the migration process (together with the NPV of any stream of payments to continue in the future after completion of the migration process) should be treated as the 'scrap value' of the network. That is, it should be used to reduce the outstanding value of the RAB which needs to be recovered through the depreciation component of access charges. The period of cost recovery would also need to be adjusted to match the agreed shut-down date of the copper network.
- 4.28 However, in taking into account the impact of the NBN, the ACCC should apply the principle that any agreement negotiated and agreed to by Telstra should not be capable of resulting in higher access prices than would otherwise apply.

**Question 12:** *whether rate shocks are likely to be a concern in the telecommunications context? If so, what approach should be taken to reducing the size of the rate shock?*

- 4.29 The ACCC has identified the potential for 'jumps' in allowed earnings (price shocks), in response to old assets being fully depreciated and replaced with new assets, which are not likely to be well received by access seekers and end-users. In response to this perceived problem, the ACCC has identified a number of options available for creating a more continuous path of earnings over time.
- 4.30 Optus considers that the issue identified by the ACCC is unlikely to become a real problem. It could only arise if Telstra undertook significant investment in order to construct the 'new assets' under consideration by the ACCC.

- 4.31 However, in practice it is unlikely that significant investment will be undertaken by Telstra. As a result of the Government's NBN project, Telstra's CAN is likely to be rendered redundant within 7 to 8 years.<sup>66</sup> Further, Telstra is currently negotiating with NBNCo for a deal in which Telstra is expected to agree to 'switch off' its legacy network and migrate its retail customers across to the NBN. As noted above, Telstra is an active participant in these negotiations<sup>67</sup> and expects to reach an agreement, with NBNCo.
- 4.32 Consequently, Optus considers that Telstra will not make further major capital investments in the CAN (as opposed to simply operating and maintaining the CAN). Optus submits therefore that special measures designed to respond to such investments (ie the options identified by the ACCC for creating a more continuous path of earnings over time) will not be required.
- 4.33 In any case it is not necessary for the ACCC to decide this question at this point in time. The ACCC will be in a better position to form a view on the likelihood of Telstra making major capital investments in the CAN if and when a deal between Telstra and NBNCo is finalised and the salient information (the assets involved, the traffic migration aspect, the consideration, the agreed shut-down date of the copper network) is known. The ACCC should wait to take that information into account, and will be in a position to take submissions from interested parties on this issue at that time (and also at a later stage, in the unlikely event that Telstra does submit plans for significant capex at some point in the future).

**Question 13:** *whether the approach to depreciation should be the same for all classes of assets in the RAB? Why/why not?*

- 4.34 It might be argued that different approaches to depreciation for different classes of assets in the RAB are justified on the basis of competition; the ACCC has noted that the prospects for future infrastructure based

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<sup>66</sup> Given that the NBN – unlike the CAN – is best-in-use technology and that the NBN will be an open access wholesale network with very strong natural monopoly characteristics, it follows that the NBN will make the existing copper access network (CAN) redundant (throughout the entire length of the copper loop from exchange to customer premises). Optus submits that that the CAN will largely no longer be required after the NBN comes into operation and that any continuing use will be limited and temporary. Users will be able to achieve significantly faster speeds on the NBN compared to the CAN immediately it is constructed and in the foreseeable future. DBCDE in its NBN policy paper considers that "Fibre optic to the home and workplace technology (or FTTP) is the state of the art 'future proof' fixed broadband technology and is capable of providing customers with download speeds of 100 Mbps and upload speeds of 50 Mbps." (DBCDE, *21st Century Broadband*, Policy Brochure, April 2009, p.4) This is comparable to the current achievable access speeds of up to 20Mbps offered on Telstra's ADSL 2+ network. (In reality, actual speeds may vary due to technical factors. Therefore, as Telstra's disclaimer notes "About 70 per cent of members on the 8Mbps plan can access speeds around 6Mbps or more. About 50 per cent of members on the 20Mbps plan can access speeds around 10Mbps or more." Telstra, ADSL Broadband, Available from URL:

[http://www.telstra.com.au/bigpond\\_internet/adsl2.html](http://www.telstra.com.au/bigpond_internet/adsl2.html) (accessed 18/5/09))

<sup>67</sup> Telstra, "Telstra formalises Terms of Engagement with NBN Co," Media Release, 18 December 2009

competition should be considered, since this might reduce the operator's ability to recover costs in later years. It might be argued for example that a different approach to depreciation was required for asset classes for which the price is rising (say, trenches) compared to asset classes for which the price is falling (say, electronics).

- 4.35 However, as noted above under question 10, the costs of replacing the network infrastructure associated with the CAN as a whole are likely to be rising in line with labour costs. Whilst the equipment replacement costs for some classes of assets in the RAB (say, electronics) may be falling, these are likely to be outweighed by labour costs and other rising costs over the RAB as a whole, the cost of which is dominated by trenching costs. This has been the experience in recent years in which the replacement cost of the CAN has been rising notwithstanding falls in some equipment costs such as electronics.
- 4.36 Further, any competition faced by the network provider would be on the basis of the network as a whole; competitors cannot provide network access services using only an isolated class of assets (eg, switches). It follows that the costs of the whole network are relevant: it does not make sense to argue on competition grounds for a different approach to some class of assets. There is therefore no justification for, for example, frontloading the costs of any particular class of assets.
- 4.37 More importantly, however, as discussed above Telstra does not face a risk of future infrastructure based competition. It follows that there is no justification for applying a frontloaded depreciation schedule that allows Telstra more cost recovery in the earlier years of the new regime – and there is no justification for varying this approach with respect to any particular asset class.
- 4.38 Consequently, Optus submits that the approach to depreciation should be the same for all network assets.
- 4.39 Land may require special consideration. Optus submits that Telstra's RAB should be adjusted downwards on an ongoing basis to account for its opportunities for future cost recovery resulting from the sale of property at significant profit over the original purchase cost (particularly as its exchanges become obsolete during the transition to the NBN). This very significant source of cost recovery should be taken into account in determining the approach to depreciation for land going forward.

**Question 14:** *what is the appropriate period over which to recover these costs — i.e. appropriate asset lives?*

- 4.40 On one view, the appropriate future period to recover ongoing costs should be the period for which the relevant network assets are able to be operated. It is worth noting, however, that in a regime of the type under consideration (involving roll forward of a RAB), it is by no means necessary that the period of cost recovery be linked to asset lives. The central objective is financial capital maintenance, and guiding

considerations include fairness to investors, efficiency and promotion of competition. It is by no means required for reasons of economics that financial capital maintenance must be achieved inside a particular timeframe which is linked to the economic life of the assets under consideration. Nevertheless, such a link may be considered convenient.

- 4.41 In the general case (ie without considering the NBN), attention may thus be paid to the remaining useful life of each network element before it wears out and requires replacement. In determining the remaining life of assets for cost recovery purposes, it is important to guard against underestimating the remaining life. For example, 20 years is often quoted as an appropriate asset life for copper cable, however the copper cable in many telecommunications networks has proven to be far longer lived than this. The asset lives for copper cable and duct used in the Analysys model were too short, compared to those used for similar equipment in other jurisdictions.<sup>68</sup>
- 4.42 Turning to the impact of the NBN, the transition from Telstra's network to the NBN may impact upon the period over which Telstra will be able to recover its ongoing costs. Once all customers have migrated to the NBN, Telstra will no longer be able to recover its network costs through wholesale access charges (although there may be ongoing payments from NBNC0 for use of trenches and/or ducts, if the deal with NBNC0 takes this form).
- 4.43 This does not mean, however, that Telstra should be given the opportunity to raise access prices via accelerated depreciation in the period leading up to the migration. Whilst it is true that as a result of its deal with NBNC0 Telstra will be foregoing the opportunity to earn revenue through its network after the migration is complete, it is also critical to understand that Telstra will be compensated for that foregone revenue through the payment(s) it will receive from NBNC0, which may exceed Telstra's total unrecovered costs, as discussed above.
- 4.44 The implication is that Telstra's RAB will require adjustment as a result of the Telstra-NBNC0 deal. The value of the RAB (that is, the value of capital costs remaining to be recovered) may even become negative. It follows that a shortened period of cost recovery does not require accelerated depreciation in order to ensure Telstra recovers its costs.
- 4.45 Again, as argued above, it is not necessary for the ACCC to decide this question at this point in time. The ACCC will be in a better position to form a view on the appropriate period over which to recover costs if and when a deal between Telstra and NBNC0 is finalised and the salient information (the assets involved, the traffic migration aspect, the consideration, the agreed shut-down date of the copper network) is known. The ACCC should wait to take that information into account, and will be in a position to take submissions from interested parties on this issue at that time.

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68 Network Strategies, *ULLS: review of the ACCC draft decision*, October 2009, p.32-33

## 5. Incentive mechanisms

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### Incentives to improve productivity

**Question 15:** *whether mechanisms are required in order to encourage access providers to incur costs efficiently?*

- 5.1 The ACCC expressed the view in its discussion paper that consideration needs to be given to how to encourage efficiencies in Telstra's expenditure decisions. This view is motivated by the concern that Telstra may incur costs inefficiently and pass these on in access prices. In order to address this issue the ACCC has raised the possibility of 'de-linking' actual costs from forecast costs, and has stated that roll forward based on forecast capex and forecast depreciation leads to high-powered incentives to reduce capital expenditure.
- 5.2 Optus does not support such an approach. First, Optus considers it unlikely that significant network expenditure will be undertaken by Telstra. As a result of the Government's NBN project, Telstra's CAN is likely to be rendered redundant within 7 to 8 years.<sup>69</sup> Further, Telstra is currently negotiating with NBNCo for a deal in which Telstra is expected to agree to 'switch off' its legacy network and migrate its retail customers across to the NBN. Telstra is actively participating in these negotiations<sup>70</sup> and expects to reach an agreement.<sup>71</sup> In these circumstances it is unlikely that Telstra will incur further major capital expenditure in its network (as opposed to simply operating and maintaining it). Optus submits that the ACCC's concern that Telstra may incur costs inefficiently is likely to be overstated and does not warrant the introduction of mechanisms to encourage cost efficiency.
- 5.3 Second, the ACCC can address efficiency concerns to some extent by commissioning expert network engineering consultants to review the

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69 Given that the NBN – unlike the CAN – is best-in-use technology and that the NBN will be an open access wholesale network with very strong natural monopoly characteristics, it follows that the NBN will make the existing copper access network (CAN) redundant (throughout the entire length of the copper loop from exchange to customer premises). Optus submits that the CAN will largely no longer be required after the NBN comes into operation and that any continuing use will be limited and temporary. Users will be able to achieve significantly faster speeds on the NBN compared to the CAN immediately it is constructed and in the foreseeable future. DBCDE in its NBN policy paper considers that "Fibre optic to the home and workplace technology (or FTTP) is the state of the art 'future proof' fixed broadband technology and is capable of providing customers with download speeds of 100 Mbps and upload speeds of 50 Mbps." (DBCDE, *21st Century Broadband*, Policy Brochure, April 2009, p.4) This is comparable to the current achievable access speeds of up to 20Mbps offered on Telstra's ADSL 2+ network. (In reality, actual speeds may vary due to technical factors. Therefore, as Telstra's disclaimer notes "About 70 per cent of members on the 8Mbps plan can access speeds around 6Mbps or more. About 50 per cent of members on the 20Mbps plan can access speeds around 10Mbps or more." Telstra, ADSL Broadband, Available from URL: [http://www.telstra.com.au/bigpond\\_internet/adsl2.html](http://www.telstra.com.au/bigpond_internet/adsl2.html) (accessed 18/5/09))

70 Telstra, "Telstra formalises Terms of Engagement with NBN Co," Media Release, 18 December 2009

71 Telstra, "Analysing Telstra's impending separation: the options," David Quilty, GMD, Public Policy & Communications, Speech, 7 December 2009



prudence and efficiency of actual expenditure decisions. Optus notes that even where roll forward was based on forecast capex, the ACCC would need to commission similar reviews. If the expenditure were found to be imprudent or unnecessary, then it can and should be ruled ineligible for inclusion in the RAB or any other mode of compensation. Reviews of actual expenditure for prudence would address the ACCC's concern that Telstra may incur costs inefficiently and pass these on in access prices.

- 5.4 Further, Optus considers that the ACCC's suggested de-linking of actual costs from forecast costs is likely to cause more serious problems than those it is intended to solve. Whilst the ACCC has stated that roll forward based on forecast capex and forecast depreciation leads to high-powered incentives to reduce capital expenditure, in Optus' view such a regime would be more likely to lead to high-powered incentives to game the system by inflating forecasts.
- 5.5 This is because such mechanisms rely on forecasts of capital expenditure. In these circumstances the asset owner has an asymmetric information advantage over the regulator,<sup>72</sup> and has the ability to pad its asset base with high forecasts. This would likely be the case for Telstra. CEG has considered the opportunities and incentives for Telstra to engage in regulatory gaming under a regime involving roll forward based on forecast expenditure. CEG found that:

*"...knowledge of future demand, network condition, and the relationship between service quality and expenditure are essential to forecasting expenditure requirements in incentive arrangements, yet these are the domain of the access provider rather than the regulator, particularly early in a regulatory regime where the regulator is yet to 'learn' how to judge expenditure forecasts as being prudent and required..."*<sup>73</sup>

- 5.6 It is the consistent experience in other industries that efficient investment incentives necessarily advantage the asset owner especially in the early stages of a regulatory regime. As CEG has noted:

*"...it is common for there to be large discrepancies between out-turn expenditure and forecast expenditure despite scrutiny of forecasts by the regulator... regulators have considered mechanisms to elicit more truthful forecasts and/or minimise the power of incentives in light of uncertainty regarding forecasts..."*<sup>74</sup>

- 5.7 CEG's report is attached as Attachment 2.
- 5.8 Given the likelihood that Telstra's future capital expenditure requirements on the CAN will be relatively low and the significant gaming opportunities that would be introduced by the ACCC's proposed 'de-linking' of actual costs from forecast costs, Optus submits that

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72 Information asymmetry is defined as the study of decisions in transactions where one party has more or better information than the other. This creates an imbalance of power in transactions.

73 CEG, 2010, *Past cost recovery and asset valuation* (attached as Attachment 2)

74 CEG, 2010, *Past cost recovery and asset valuation* (attached as Attachment 2)

Telstra's compensation should be linked to actual expenditure, subject to review of prudence and efficiency by the ACCC. This *ex post* review of actual expenditure will ensure that tariffs are determined only by reference to prudent and efficient capex. No mechanisms should be introduced in order to encourage access providers to incur costs efficiently.

***Question 16:*** *in the context of a pricing approach which locks-in and rolls-forward the RAB, the mechanisms that should be adopted to create incentives to incur efficient capital expenditure?*

5.9 No further mechanisms should be adopted to create incentives to incur efficient capital expenditure. See answer to question 15 above.

***Question 17:*** *in the context of a pricing approach which locks-in and rolls-forward the RAB, the mechanisms that should be adopted to create incentives to incur efficient operational expenditure?*

5.10 For the reasons set out in answer to question 15 above, there is a significant risk of gaming involved in trying to establish further incentives relating to efficient expenditure. Optus submits that no further mechanisms should be adopted to create incentives to incur efficient operational expenditure. See answer to question 15 above.

***Question 18:*** *whether if the RAB is locked in or re-valued impacts upon which efficiency mechanisms will encourage efficiencies in capital and operations expenditure?*

5.11 As noted above, Optus submits that no mechanisms need to be introduced in order to encourage access providers to incur costs efficiently. See answer to question 15 above.

5.12 Regular revaluation of the RAB does not create any incentive to invest in the network, since under a revaluation regime (such as the current regime) there is no link between network expenditure and access prices. Revaluation rewards the incumbent for investments that are never actually made. As a result Telstra would continue to enjoy windfall gains as a result of increasing network replacement costs.

5.13 Optus submits that compensation should be linked to actual expenditure, subject to prudence checks by ACCC. This is consistent with a 'lock in' approach to the RAB.

**Question 19:** *what the appropriate length of time between reviewing regulated prices (i.e. an appropriate length for the regulatory period) is, and why?*

5.14 The ACCC has noted the relevance of cost and demand conditions in the telecommunications sector to the appropriate length for the regulatory period. Optus considers that cost and demand conditions are highly uncertain. For example, Telstra's 2009 Annual Report illustrates that its number of PSTN SIOs has varied quite considerably on a half-yearly basis since December 2006.<sup>75</sup> Moreover, these fluctuations are often unanticipated. For example, speaking at Telstra's analyst briefing on its half-year results, CEO David Thodey highlighted the volatility and unpredictability of Telstra's PSTN business, noting that:

*"...The decline has been more severe and pronounced than we had anticipated, as I said, six months ago and even two months ago."*<sup>76</sup>

*"...It has accelerated faster than we had expected, and it has been an accelerating trend."*<sup>77</sup>

5.15 As a result of the relative uncertainty of demand conditions in the telecommunications industry, it would be appropriate that the regulatory period be of shorter duration than in other regulated industries.

5.16 Further, as discussed above under question 15, Optus is concerned that Telstra will take advantage of opportunities to game the system by inflating its forecasts. Optus has proposed that in order to reduce this opportunity, compensation should be linked to actual expenditure. However, the ACCC will nevertheless be forced to rely on forecasts in the short term, since actual expenditure will not be immediately available. At the end of the regulatory period the ACCC will need to adjust Telstra's RAB to account for any discrepancy between forecast and actual expenditure. Given that any such discrepancy will endure for at least some period of time before the 'true-up' takes place, Telstra would retain its ability to profit in the short term by inflating its forecasts. And the longer is the regulatory period (the period before the 'true-up' occurs) the greater is Telstra's ability to profit by gaming the forecast and the longer that profit will endure before it is clawed back.

5.17 It follows that the longer is the regulatory period the greater is the damage to competition and to Telstra's competitors, and to end users who will be paying inflated prices. Consequently, Optus considers that in order to minimise the deleterious effects of regulatory gaming of forecasts by the service provider, it would be appropriate that the regulatory period be of shorter duration than in other regulated industries.

5.18 Finally, as discussed above, the ACCC will need to make adjustments to Telstra's RAB to take into account of the consideration Telstra receives

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<sup>75</sup> Telstra, *Annual Report 2009*, September 2009, p.13

<sup>76</sup> Telstra, *Telstra half-year results 2010 – Analyst briefing*, Transcript, 11 February 2010, p.6

<sup>77</sup> Telstra, *Telstra half-year results 2010 – Analyst briefing*, Transcript, 11 February 2010, p.27

in any deal which is reached with NBNCo in exchange for shutting down its network and providing access to its ducts. In order to prevent over-recovery, it is important that this adjustment be made as soon as possible after any such deal is struck. The need for urgency is compounded by the fact that Telstra's CAN is likely to be shut down when the NBN becomes operational – once this occurs it will no longer be possible for the ACCC to reverse any over-recovery which Telstra has made.

- 5.19 For all of these reasons, Optus submits that the length of the regulatory period should be no more than three years. While this is shorter than the periods typically used in other sectors, it is important that the regulatory regime is able to adapt and respond quickly to developments such as the roll out of the NBN and any deal between Telstra and NBNCo. The current potential for conditions to change rapidly requires a much shorter regulatory horizon.

**Question 20:** *whether there should be the opportunity for regulated prices to be reviewed in the middle of a regulatory period, in response to particular events? If so, what events should be considered?*

- 5.20 The ACCC has raised the possibility that unforeseen capital expenditure may be required that was not anticipated at the start of the regulatory period, which might imply that the access provider is unable to recover the costs of this investment.
- 5.21 However, under Optus' preferred system, compensation for Telstra would be linked to actual expenditure, subject to prudence checks by ACCC. With a link to actual expenditure, the issue identified by the ACCC does not arise. The access provider will be able to recover the costs of all investment which has been prudently incurred.
- 5.22 Further, as noted in the response to the previous question, the length of the regulatory period should be no more than three years. Given that the regulatory period will be relatively short, there will be frequent opportunities at the end of each regulatory period to compensate Telstra for costs incurred during the regulatory period – including any unexpected costs incurred in response to particular events.
- 5.23 Consequently, Optus submits that there should be no opportunity for regulated prices to be reviewed in the middle of a regulatory period in response to particular events which require unexpected additional costs to be incurred.
- 5.24 However, it may be appropriate for regulated prices to be reviewed in the middle of a regulatory period in response to events of a different nature. In particular (as discussed earlier in this submission), if a deal is struck between Telstra and NBNCo during the course of a regulatory period, then the ACCC should take the deal into account once the relevant information is known. Optus submits that the ACCC should stand ready to adjust Telstra's RAB and access prices in a timely manner in order to prevent over-recovery and prevent access seekers and end users from

continuing to bear access prices that are higher than is consistent with cost recovery for any significant period of time. This may require action during the course of a regulatory period.

### **Incentives to maintain service quality**

**Question 21:** *whether the current model non-price terms and conditions and relevant industry codes would provide a sufficient balance for the strength of the incentives created by the mechanism to minimise costs recommended by the interested party in their response to questions 16 and 17?*

- 5.25 The ACCC has raised the concern that if it introduces regulation that creates strong incentives to reduce costs then there is a risk that Telstra may try to do so by reducing the quality of services offered to users. It has suggested the introduction of some financial incentive scheme for quality of service in order to address this concern.
- 5.26 Optus considers that quality of service is unlikely to lead to the problems anticipated by the ACCC, for a number of reasons.
- 5.27 First, as discussed above under question 15, Optus has not recommended that any mechanisms be introduced in order to minimise costs. Rather, Optus considers it appropriate that Telstra's compensation is linked to actual expenditure, subject to prudence review by the ACCC. It follows that the ACCC need not be concerned that incentives to reduce costs will interfere with Telstra's incentives to maintain service quality. Rather, under Optus' proposed regime, Telstra will be given the incentive to undertake prudent required expenditure on the network, for which it will be fully compensated.
- 5.28 Second, financial incentive schemes for quality of service are likely to be susceptible to gaming issues. The ACCC may have difficulty setting appropriate quality of service targets, and may set the wrong targets, particularly in the early years of the regime. If targets are too low the service provider obtains a financial benefit without needing to exert any effort. If targets are too high the service provider would not even attempt to improve quality. Telstra is likely to have an asymmetric information advantage over the ACCC with regard to quality of service (much as it does with respect to volume as described under question 15 above). Optus considers that Telstra is likely to have the ability to game financial incentive schemes for quality of service to its own advantage (particularly in the early years of the regime).
- 5.29 Third, issues around quality of service incentives are likely to be less significant in telecommunications compared to the energy sector. Compared to electricity network owners Telstra will have less incentive to let the network fall into disrepair, since it requires the network to be operational in order to serve its own retail customers. This would be true where Telstra is unable to make a distinction between the quality experienced by its own customers and quality experienced by access seekers' customers (eg maintenance of trunk lines in the access network).

- 5.30 Telstra's incentives are quite different for aspects of service quality where Telstra *is* able to make a distinction between the quality experienced by its own customers and the quality of service experienced by access seekers' customers (typically non-network issues). In such circumstances Telstra can and does discriminate against access seekers' customers and provide a quality of service to access seekers which is inferior when compared to the service it provides itself. A significant example is the access dispute lodged by Optus over the provisioning of ULLS to multi-dwelling units. Other access disputes have been lodged over various non price issues including service level agreements (SLAs) for provisioning, activation times, bulk service qualification, billing payment terms, indemnity for third parties and Telstra's ability to amend operational documents unilaterally. Certainly the current model non-price terms and conditions and relevant industry codes have not always been effective in ensuring Telstra's provision of service to access seekers has been of high quality.
- 5.31 It is clear from the above list that the service quality issues which Optus has identified in the past relate mainly to non-network issues such as ordering and provisioning for third party access. However, the ACCC appears to be more concerned with network quality issues (given its focus on the cost minimisation incentives related to opex and capex) which are less likely to eventuate. Optus considers that service quality issues relating to non-network issues such as ordering and provisioning for third party access are a matter of serious concern and should be addressed by the ACCC. However, for the reasons noted in the paragraphs above they should not be addressed by introducing a financial incentive scheme for quality of service.
- 5.32 Optus submits that a financial incentive scheme for quality of service is not necessary and should not be introduced.

***Question 22: if additional schemes to maintain services standards are recommended, whether a financial incentive scheme or a non-financial incentive scheme should be adopted? What should the schemes look like?***

- 5.33 As noted above under question 21, Optus does not recommend a financial incentive scheme to maintain service standards.

## 6. Cost allocation and price setting

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### Allocating costs to different telecommunication services

**Question 23:** *the degree to which the ACCC or the access provider should allocate the costs of service provision to — and therefore set the individual prices of — different fixed line services? Consider the implications of vertical and horizontal structure in your response.*

- 6.1 The ACCC has raised the possibility of Telstra being given freedom to allocate costs to set the prices of individual services, within the constraint of the ACCC regulating a maximum allowable revenue or an average price cap. It has noted that pricing flexibility can result in pricing structures that align with consumer preferences and demand conditions, and that a certain degree of flexibility has been allowed in other industries.
- 6.2 However, the ACCC has also recognised that the access provider may not have the incentive to set access prices efficiently, and that flexibility might lead to less certainty for access seekers, particularly if demand conditions were uncertain. In this regard Optus notes that – as discussed above under question 19 – demand conditions in the telecommunications industry are indeed likely to be uncertain, particularly when compared to other industries.
- 6.3 The ACCC has also identified a significant competition concern with pricing flexibility:
- A key determinant of whether pricing flexibility is likely to be desirable in practice is the degree to which the access provider is vertically integrated. Competition issues could arise depending on the degree of the access provider's vertical integration — allowing it the flexibility to set access prices may allow it to prevent or delay entry by new entrants into certain markets. For example, a vertically integrated access provider might allocate a large proportion of costs to the lowest layer service (e.g. the ULLS) to discourage access seekers from purchasing this service.<sup>78</sup>*
- 6.4 Given that Telstra is a highly vertically integrated service provider, this competition concern should be taken very seriously indeed. Optus is extremely concerned that Telstra would have the ability and incentive to discriminate against particular modes of access (such as the ULLS) and against particular access seekers (perhaps those seen as posing the most serious threat to Telstra's dominance) by raising the prices of those services on which they are most dependent.

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<sup>78</sup> ACCC, *Review of 1997 Guide to telecommunications access pricing principles for fixed line services*, Discussion Paper, December 2009, p.53

6.5 Whilst the ACCC has alluded to the possibility of attempting to control such incentives using side controls (e.g. on the quality of service, on the speed of price rebalancing), the effectiveness of such controls must be subject to grave doubt. Such controls may be effective in industries where vertical integration is not present, but in telecommunications vertical integration concerns are highly problematic and, it is submitted, it is very likely that Telstra would find a way to misuse any flexibility it was given, despite attempts to prevent this using side controls.

6.6 CEG has considered the opportunities and incentives for Telstra to engage in anticompetitive discrimination under a regime allowing it pricing flexibility. CEG found a regime allowing the access provider pricing flexibility (such as a weighted average price cap) was unlikely to align the interests of the vertically integrated monopolist (Telstra) and society, noting that:

*“...cost conditions that allow the vertically integrated access provider to damage or displace its rivals through fewer sales will give the access provider incentive to favour its retail arm over access seekers. Whilst access seekers may provide an alternative avenue for efficient price discrimination, the opportunity to distort the access pricing menu to harm competition will remain...”*<sup>79</sup>

6.7 CEG’s report is attached as Attachment 3.

6.8 In conclusion, it is not appropriate that the access provider have flexibility to set the individual prices of different fixed line services. Optus submits that the ACCC should allocate the costs of service provision to — and therefore set the individual prices of — different fixed line services.

**Question 24:** *if the ACCC continues to allocate costs to individual services, as occurs today, what approach it should use to allocate these costs — for example, the approach adopted in the Analysys cost model, the RAF accounts, etc?*

6.9 Optus considers that the cost allocation approach adopted should be transparent and objectively measurable. To the extent possible, costs should be apportioned to a service from the network elements over which the service is provided. Further, the approach should not be subject to significant information asymmetry problems and should avoid (to the extent possible) creating opportunities for regulatory gaming.

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<sup>79</sup> CEG, 2010, *Access price flexibility with a vertically integrated access provider* (attached as Attachment 3)



## *RAF accounts*

- 6.10 An important component of the RAF Record-Keeping Rules (RKR) <sup>80</sup> is the allocation of costs amongst various services and asset types. The RAF RKR explanatory documentation list the allocation methodology that is to be applied with respect to each line item. However these guidelines are relatively broad and non-specific. For example, for many items the cost allocation is to be determined according to 'usage' but the RAF RKR does not provide any further guidance. The interpretation of the 'rules' is left to individual carriers. Such flexibility allows carriers to apply allocation criteria that best match their internal weightings and/or data recording systems.
- 6.11 The way in which individual carriers interpret the RAF RKR is outlined in their Regulatory Accounting Procedures Manual (RAPM). The RAPM is submitted to the Commission as an attachment the formal RAF report, although RAPMs and RAF data are not disclosed to other parties.
- 6.12 Optus considers that if Telstra's RAF accounts were used to allocate costs across services then the approach adopted in the RAF accounts might be broadly reasonable, however this conclusion is subject to a number of caveats. Optus would be highly concerned if the RAF accounts became the sole basis for cost allocation, since this method:
- would not be procedurally fair;
  - cannot be properly scrutinised; and
  - is open to regulatory gaming.
- 6.13 Optus does not possess direct knowledge of the methods Telstra uses to prepare its RAF accounts (ie it is non-transparent) which means to apply such a process would not be procedurally fair to all parties. Regardless of the fact that Telstra's RAPM is not disclosed, as noted previously, the application of the RAF RKR is very subjective which means that Telstra is highly likely to apply a different allocation methodology to, for example, Optus.
- 6.14 Whilst Optus is familiar with practical issues surrounding the allocation of RAF costs, the various allocation methodologies applied by Optus are chosen because they best suit Optus' internal processes (e.g. internal accounting methods, data collection, etc). However, Optus does not know what specific allocation methods are used by Telstra.
- 6.15 As a result of these issues, using Telstra's RAF as the basis for cost allocations would effectively leave the industry out of the decision-making process as only the Commission and Telstra would be able to

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<sup>80</sup> The objectives of the RAF are set out in s151BU of the Act and the Commission's RAF Record-Keeping Rules (RKR). The RAF RKR requires certain carriers to annually supply the Commission with various financial information and usage-related data. The specific schedule of required information is contained in ACCC, *Telecommunications Industry Regulatory Accounting Framework (Record-Keeping Rules)*, October 2003.

comment whether the allocation methods were appropriate. Optus submits that to apply such a process would not be procedurally fair.

- 6.16 Further, Telstra might seek to make substantial changes to the way it prepares its RAF accounts (with or without ACCC authorisation). For example, it is possible that Telstra could deliberately manipulate its RAF accounting methodology in order to discriminate anti-competitively against access-seekers (e.g. through increases to certain access prices). To the extent such regulatory gaming was possible it would clearly undermine a RAF-based allocation system.
- 6.17 Optus considers that even with ACCC oversight this possibility may not be stamped out. Cost allocation is an area where Telstra has a significant and enduring asymmetric information advantage over the regulator (and access seekers). Although the Commission will be able to use some methods to determine the reasonableness of RAF figures at an aggregate level (e.g. use of historic trends and general industry data), it will have very little information on how this data should be allocated (apart from perhaps benchmarking values). Further, given that usage data is collected in a number of different ways (which are likely to be unique to Telstra) it may be difficult for it to assess the accuracy of such data. Such concerns could be overcome through a specific consultation with industry on the appropriate cost drivers for material CAN-related capex and opex.

#### *Analysys model*

- 6.18 The approach to cost allocation adopted in the Analysys cost model involves determination of the usage of network elements by various services. Costs are allocated according to the resulting table of routing factors which enable the costs of assets to be apportioned across the relevant service platforms. The aggregation of the routing factors results in the construction of a 'routing table' which form the basis of all cost allocation decisions.
- 6.19 From this routing table (i.e. allocation), capital and operating and maintenance costs directly attributable to the different platforms are accounted for, and then "*[t]he sum of the platform costs are divided by the total volume demand to generate the per unit network output.*"<sup>81</sup>
- 6.20 The rationale for this traffic-based approach to cost allocation is that assets costs will be mainly driven by the traffic which is transmitted or routed across the network. As the ACCC noted in its discussion paper, TSLRIC+ could be applied using historic costs — that is, for example, without continually re-valuing the RAB, but rather locking in its value and rolling it forward. The allocation of costs (capital costs and operations and maintenance expenditures) to the different fixed line services could nonetheless then be undertaken in the same manner in which it is currently.

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<sup>81</sup> Analysys, *Fixed LRIC cost model documentation*, December 2008, p.121

- 6.21 Optus considers that the approach to cost allocation adopted in the Analysys cost model is broadly reasonable. The main advantages of using a routing table are that it would provide for a highly transparent and objective approach. The routing factors could be made publicly available to allow discussion amongst the industry as to the appropriate setting of each parameter. Further, this degree of transparency would also minimise opportunities for regulatory gaming.

### *Linesharing*

- 6.22 However, this conclusion is subject to a caveat relating to the line sharing service (LSS). Under the present system the wholesale access charge for the LSS is based on only the cost of the incremental or LSS-specific component of costs. The LSS access charge does not make any contribution to the common costs of the infrastructure over which the service is carried (the copper loop).
- 6.23 The reason the LSS does not bear any share of common line costs is because the ACCC has found that there are other revenue streams from which Telstra is able to recover the full cost of the line through wholesale (line rental) and retail pricing, noting that: *“Where Telstra is recovering its line-related costs through other revenue sources, the Commission believes it would be inappropriate to include any allocation of line costs in the price of a LSS.”*<sup>82</sup>
- 6.24 Optus considers that the fact the LSS does not bear any share of common line costs is inappropriate and distortionary. The ACCC is on record as being in agreement with this principle, as is apparent from the following comments made by the ACCC in 2007:
- “...economic efficiency can be enhanced by the inclusion of an appropriate contribution to line costs in LSS annual charges. However, where line rental charges fully recover costs, the inclusion of such a contribution in LSS annual charges would lead to an over-recovery of cost. In these circumstances, reductions in charges for other network services, such as wholesale line rental, are needed in order to avoid any such ‘double dipping’.”*<sup>83</sup>
- 6.25 Optus notes the ACCC’s suggestion that reductions in charges for other network services, such as wholesale line rental, would be needed in order to prevent cost recovery. Telstra has alluded to this matter in the past in its submission that *“LSS and WLR charges could be rebalanced within a matter of weeks of the Commission advising its view on the amount of line cost that should be allocated to each service.”*<sup>84</sup> Optus considers that the

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82 ACCC, *Line sharing service*, Final Decision, August 2002, p.iv

83 ACCC, *Access Dispute between Chime-Telstra – Line Sharing Service (LSS)*, Final Determination and Associated Statement of Reasons, 12 July 2007, p.1

84 ACCC, *Access Dispute between Chime-Telstra – Line Sharing Service (LSS)*, Final Determination and Associated Statement of Reasons, 12 July 2007, p.26

current consultation provides an opportune time for the ACCC to consider the scope for rebalancing.

- 6.26 In conclusion, Optus submits that in order to allocate costs to individual services the ACCC should use an approach based on allocating costs according to each service's usage of network elements. The approach to cost allocation adopted in the Analysys cost model is one example of this.

**Question 25:** *if the access provider is to be allowed a degree of pricing flexibility, how should this be implemented — should a revenue cap be regulated? Or should a weighted average price cap be regulated?*

- 6.27 As noted above under question 23, it is not appropriate that the access provider has flexibility to set the individual prices of different fixed line services. Optus submits that neither a revenue cap nor a weighted average price cap should be introduced.

**Question 26:** *if regulating weighted average price caps, which services should be included in which baskets? On what basis should the prices be weighted?*

- 6.28 As noted above under question 23, it is not appropriate that access prices be regulated according to a weighted average price cap.

**Question 27:** *should the same approach be adopted for all services, or should flexibility be allowed in the pricing of some services but not others?*

- 6.29 Optus considers that it is not appropriate that any access prices be regulated according to a weighted average price cap, for the reasons discussed above under question 23.

### **Averaged versus de-averaged access charges**

**Question 28:** *whether access prices should be averaged or de-averaged across regions? For which services?*

- 6.30 In broad terms, the approach taken by the ACCC to the question of whether access prices should be averaged or de-averaged across regions has generally been “to assess the structure of access pricing on a service by service basis rather than taking a single position on averaging or de-averaging.”<sup>85</sup> The ACCC has typically stated a preference for de-averaged pricing where cost differences across regions are large.
- 6.31 Optus agrees that the question should be considered on a service by service basis.

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<sup>85</sup> ACCC, *Draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, Draft Determination, August 2009, p.20

## The ULLS

- 6.32 The ACCC has for some time maintained a policy of setting separate ULLS prices for each of four geographic bands, given the significant variation between these bands in the cost of local loop infrastructure.<sup>86</sup> In its ULLS pricing principles<sup>87</sup> and in its determinations on various ULLS access disputes<sup>88</sup>, ULLS prices have been set based on a geographic de-averaged price structure since the service was first declared in 1999.<sup>89</sup>
- 6.33 The ACCC has emphatically rejected previous attempts by Telstra to have prices set on a geographically averaged basis. In its December 2005 ULLS undertaking Telstra proposed a geographically averaged price of \$30 per month across all geographic Bands. The ACCC was highly critical of this approach and rejected the undertaking and the principles of geographic averaging.<sup>90</sup> On appeal the Australian Competition Tribunal supported the ACCC's conclusions and rejected the undertaking.<sup>91</sup>
- 6.34 The consistent determination of geographically de-averaged ULLS prices has had significant practical implications. Access seekers have made substantial investments in DSLAM infrastructure in Band 2 in reliance on the ACCC's pricing approach to ULLS. A shift away from de-averaged ULLS pricing now would result in expropriation of those investments and would discourage investment in infrastructure in the long term. As acknowledged by the ACCC in its assessment of Telstra's 2008 Band 2 ULLS monthly charge undertaking,<sup>92</sup> there is a strong correlation between the uptake of ULLS and Band 2 ULLS indicative prices. The ACCC has recognised that “[t]he ULLS price is an important factor in encouraging new investment in, and further augmentation to the ULLS-based network, as access seekers incur this cost when delivering

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<sup>86</sup> The rationale for the ACCC's policy was that prices should be cost-reflective. The bands are defined by substantial differences in teledensity, and network costs per line are closely related to teledensity. As the ACCC noted in the past: “It is therefore efficient to have a pricing structure that reflects significant price differentials between different areas where there are significant cost differences, while minimising the administrative burden. To date, Telstra has generally sought to achieve this balance by proposing a banded pricing structure that reflects the different cost of providing ULLS in CBD, metropolitan, regional and rural areas.” ACCC, *Assessment of Telstra's ULLS monthly charge undertaking*, Final Decision public version, August 2006, p81

<sup>87</sup> ACCC, *Unconditioned local loop service (ULLS) – Final pricing principles*, November 2007; ACCC, *Pricing of ULLS*, Final Report, March 2002

<sup>88</sup> ACCC, *Optus/Telstra ULLS (monthly) final determination*, March 2008; ACCC, *Chime-Telstra (monthly) final determination*, March 2008; and *Primus-Telstra ULLS (monthly) final determination*, December 2007.

<sup>89</sup> ACCC, *Unconditioned local loop service (ULLS) – Final pricing principles*, November 2007, p.17

<sup>90</sup> ACCC, *Unconditioned local loop service (ULLS) – Final pricing principles*, November 2007, p20

<sup>91</sup> The Tribunal reaffirmed that geographic averaging is inappropriate having regard to s152AB and s152AH of the Act. The Tribunal found that geographic averaging is not in the long term interests of end users. It identified many negative effects of geographic averaging. In respect of urban areas (Band 1 and 2) for example, the Tribunal considered that geographic averaging has the potential for encouraging “inefficient bypass of Telstra's CAN” and “inefficiently low levels of infrastructure investment by access seekers...” *Re Telstra Corporation Ltd (No 3)* [2007] ACompT3, para 167

<sup>92</sup> ACCC, *Assessment of Telstra's ULLS Band 2 monthly charge undertaking*, Final Decision public version, April 2009, pp78-80

*broadband/DSL and voice services to end-users, using their own infrastructure.”<sup>93</sup>*

- 6.35 Optus agrees with the ACCC’s observation in its discussion paper that to fund uneconomic services in high cost regions, mechanisms that allow transparency and accountability — such as direct subsidies — are preferable to internal cross subsidies (averaged access charges) particularly in the context of a vertically integrated access provider.<sup>94</sup>
- 6.36 Optus submits that the ACCC should not embrace averaged ULLS pricing (which it has criticised for years); rather it should continue to set prices for the ULLS according to cost-reflective geographic price bands.

#### *PSTN OTA*

- 6.37 As noted above, the ACCC has typically stated a preference for de-averaged pricing where cost differences across regions are large. However, for the PSTN OTA services, the cost differences between regions are unlikely to be large, since the cost of local loop infrastructure is not attributable to these services. It follows that averaged pricing would not be inappropriate for these services.
- 6.38 Optus submits that the ACCC should replace Telstra’s PSTN OTA tiered pricing table and, consistent with the approach that applies to termination of mobile voice calls, move to a single national rate. Such a move would be consistent with criticisms Optus has raised since 2003 about the level and structure of Telstra’s PSTN OTA rates, and in particular the arcane and overly complex nature of the pricing table that can result in significant cost over-recovery.

***Question 29: whether there should be separate RABs for different regions or a single national RAB?***

- 6.39 The ACCC has observed that having separate RABs for different regions could offer a more transparent means of monitoring and assessing how the unit costs of providing services across different regions vary, compared to if a single national RAB was adopted.
- 6.40 Optus agrees. As noted above, Optus has recommended geographically de-averaged pricing. Geographically de-averaged prices would not be truly cost-based unless different RABs were maintained for each region of interest. This approach is conceptually different to the approach of having different RABs for broad classes of assets or for different services

<sup>93</sup> ACCC, *Assessment of Telstra’s ULLS Band 2 monthly charge undertaking*, Final Decision public version, April 2009, p.81

<sup>94</sup> Optus agrees that in the context of a vertically integrated access provider, cross-subsidies can also create anti-competitive conduct concerns (e.g. the ability to price squeeze), because the source and use of the cross-subsidy is often not transparent, and it is difficult to make the access provider accountable for sourcing the cross-subsidy from and using the cross-subsidy for the services and/or regions which it is intended to be used for. ACCC, *National broadband network: Regulatory reform for 21st century broadband*, Submission to the Department of Broadband, Communications and the Digital Economy, June 2009.

(an approach Optus does not support, as discussed earlier in this submission) since a distinction between assets located in different geographical regions is meaningful and does not require any artificial allocation methodology (unlike service based RABs). It should be possible for Telstra to specify in which region it has incurred particular costs.

- 6.41 Further, having separate RABs for different regions would eliminate the need to consider any allocation methodology to distinguish revenues by geography (assuming that opex can be similarly separated). This advantage would not apply to the approach of having different RABs for broad classes of assets or for different services (as discussed earlier in this submission). Optus submits that there should be separate RABs for different regions.

**Question 30:** *if separate RABs for different regions are recommended, on what basis should these separate RABs be defined — e.g. the four band structure used for the ULLS? The Analysys model's Zones A and B? Some other basis?*

- 6.42 The simplest approach to defining separate regional RABs would be simply to retain Telstra's existing 4 band structure. Given that the existing structure reflects differences in teledensity it is likely to be correlated with cost and thus a significant improvement over a single national rate. Further, this approach has the advantages of practicability, certainty and consistency with the expectations of previous investors in infrastructure.
- 6.43 Alternatively, a new (and more cost-reflective) 4 band approach could be introduced by retaining the current Bands 1 and 2, and simply replacing Bands 3 and 4 with new bands representing the ESAs classified by the Analysys model as "clustered" and "spread" respectively within Bands 3 and 4. This would cause the access price for "clustered" Band 3 and 4 exchanges to fall relative to the pricing which would apply to the remainder of Bands 3 and 4. This alternative approach was discussed in Optus' October 2009 submission in response to the ACCC's draft determination on Pricing Principles and Indicative Prices for Fixed Line Services at pp. 97-99.<sup>95</sup>

**Question 31:** *could uniform prices for services for which a uniform price is appropriate be accommodated if regional RABs are adopted?*

- 6.44 Optus considers that uniform prices for services for which a uniform price is appropriate (eg PSTN OTA) could nevertheless be accommodated if regional RABs are adopted. Various methods could be used to achieve this, for example a weighted average price.

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<sup>95</sup> Optus, *Submission in response to the ACCC's draft determination on Pricing Principles and Indicative Prices for Fixed Line Services*, October 2009 pp. 97-99

## 7. Transition period

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### Transitory approach moving forward

*Question 32: whether, if there are changes to elements of the current approach to access pricing, access prices should be maintained at their current levels for a period of time, or alternatively, whether the current trend in access prices should be maintained for a period of time?*

- 7.1 Firms manage their operations based on expectations about the state of the markets in which they operate. Although there is a degree of uncertainty inherent in business forecasting, and even more so in an innovative industry such as telecommunications, generally this variance is diversifiable on a whole of business scale. Variations in regulatory pricing can also be forecast to a degree, but only if firms are aware of the regulator's likely position with regard to the key variables on which they will base their decision.
- 7.2 However this review is proposing a completely new pricing approach, with many issues being discussed for the first time in this industry. It is very difficult to predict the outcome of these considerations, particularly the likely magnitude of access prices based on a new pricing model. To the extent that any new access prices vary substantially from the present it would therefore be appropriate to maintain access prices at current levels for a period of time and potentially to implement a glide path as any significant changes could 'shock' the market causing a number of issues.
- 7.3 Although the distributional impact will differ, it is desirable for price shocks to be mitigated regardless of which direction access prices ultimately move. A sharp increase in ULLS prices is particularly detrimental and would undermine competition and reduce customer choice in the fixed line sector since it would:
- have a significantly adverse impact on competitors' existing investment in ULLS and rule out any further investment; and
  - deliver a windfall gain to Telstra that reinforces its privileged position in the market (as it will face lower real costs than access seekers).
- 7.4 If a service, and especially a key service such as the ULLS, is subject to a significant price change then it would be appropriate for industry to be afforded sufficient time to manage the immediate effects of any price shock that results from the implementation of a RAB pricing methodology and to make transitional arrangements. Also, it is important to note that it is not only business that is affected by shocks – effects at the wholesale level will flow through the chain of supply and ultimately affect consumers as well.



- 7.5 Optus submits that access prices should gradually transition towards new levels. Optus suggests that an appropriate ‘rule of thumb’ is that if a price change results in prices that diverge by more than 10 per cent compared to those which applied in the previous period then a glide path is likely to be required.

***Question 33: if it is desirable to maintain current prices, or the trend in current access prices for a period of time, what period of time would be appropriate?***

- 7.6 Optus considers that it would be appropriate to introduce new prices over a two to three year period.
- 7.7 If the Commission chooses to implement an adjustment path, the starting point should be the ACCC’s previously determined prices for the period ending December 2010. The glide path should be smooth, with each increment / decrement of an equal size.
- 7.8 The length of time afforded for the transition along a glide path would ultimately depend on the difference between current access prices and those implied by the new valuation. In any event the transition should be gradual and smooth.

**Attachment 1: CEG, Reform of Part XIC: Regulatory Certainty**

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[Attached as a separate document.]

**Attachment 2: CEG, Past cost recovery and asset valuation**

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[Attached as a separate document.]

**Attachment 3: CEG, Access price flexibility with a vertically integrated access provider**

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[Attached as a separate document.]

**Attachment 4: NERA, Role of TSLRIC in Telecommunications Regulation**

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[Attached as a separate document.]