



# **Submission on the ACCC's draft report - Review of fixed line pricing principles**

**A REPORT PREPARED FOR THE COMPETITIVE CARRIERS'  
COALITION**

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# Submission on the ACCC's draft report - Review of fixed line pricing principles

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## Summary of Frontier Economics report

Frontier Economics (Frontier) has been asked by the Competitive Carriers' Coalition to analyse and comment on the Australian Competition and Consumer Commission's (ACCC's) Draft report on the review of the 1997 guide to telecommunications access pricing principles for fixed line services (draft report). Our report also includes analysis of the Ovum building block model (BBM), from which the ACCC derives its indicative prices for the next four years.

Frontier supports many of the changes proposed by the ACCC. In particular, we support the locking in of the RAB, the choice of methodology to set the opening RAB (although we think it is conservative), the forecasting principles for cost and demand, the depreciation methodology, and the adoption of separate price caps for individual services.

We also recognise that the ACCC is in a position where it needs to make timely decisions so that a new pricing regime can be put into place rapidly, and that it has been hampered by a lack of quality information. Nonetheless, adopting a pricing regime based on recovery of actual costs will inevitably mean that greater scrutiny of Telstra's actual costs, and on the trends in volumes and costs, will be required.

In that context, we find that the ACCC needs to further consider the following issues before it issues final indicative prices:

- the transparency of the ACCC's inputs and calculations should be improved. Confidentiality restrictions apply to data which is critical to the ACCC's forecasts and allocation of costs. We cannot see how this can be justified given the imperative for rigorous review of inputs used to set prices for bottleneck monopoly services.
- Given the available historical evidence, the forecasts of operating and capital expenditure are likely to exceed actual costs (even without efficiency adjustments), and therefore the forecasts do not meet the standards set out by the ACCC (see Section 3).
- The demand forecasts appear to overstate likely demand falls and understate volume rises over the regulatory period, partly because demand elasticity effects are ignored (see Section 4).
- The cost allocation process is not sufficiently transparent, because it is not directly linked to the demand forecasts in the Ovum BBM model, and appears *ad hoc* (see Section 6).
- The ACCC's approach to encouraging efficient expenditure is unclear in important respects, and the proposed four-year initial regulatory period risks allowing Telstra to reap substantial profits at the expense of end-users (see Section 7).

- The indicative price set for LSS lacks an evidentiary basis and should be several times lower than its current price – even accepting the ACCC’s own cost model (see Section 8).
- Once a price path has been set, averaging or smoothing these prices over time as proposed by the ACCC does not appear to offer significant additional certainty or any other benefit, and could create problems at the commencement of next regulatory period (see Section 9).
- Indicative prices are uniformly higher than the prices derived from the Ovum BBM, often by large amounts, with no legitimate justification. When added to the opening RAB being set on a conservative basis and conservative cost and demand forecasts, this results in a double- or triple-blow for end-users (see Section 9). Our analysis suggests that the rounding of the model prices upwards means that the revenue requirement over the four years is over \$150 million higher than it should be in present value terms.

# 1 Introduction

Frontier has been asked by the Competitive Carriers' Coalition to analyse and comment on the ACCC's Draft Report on the review of the 1997 guide to telecommunications access pricing principles for fixed line services. This includes the use of the Ovum BBM, from which the ACCC derives its indicative prices for the next four years.

This is our third report to the ACCC on new fixed line pricing principles. Our previous reports are available at [www.accc.gov.au](http://www.accc.gov.au).

## 1.1 Context of this review and the importance of transparency

The ACCC's draft report marks a significant turning point in Australian telecommunications regulation. The regime since 1997 has been predicated on setting prices based on theoretical notions of cost, based on the ACCC's judgement that these costs would send important signals to access seekers. We understand that there is now widespread support for the ACCC's move to a regime based on (expected) actual cost recovery.

While we also support the moves for changes (and delivering them in a timely manner), we consider that it is important to get the details right.

The ACCC has put forward not only conceptual arguments for the change in pricing principles, but also a BBM which is used to inform its proposed draft indicative prices which are set for four years. We think that the move towards the BBM has created some significant new challenges – in particular, the ACCC is now subject to an even greater level of information asymmetry than was previously the case. Although the move away from hypothetical models is in some ways a strength, it will also be more difficult for the ACCC to 'fill in the gaps' in setting prices based on actual costs as compared to a hypothetical standard. Rather, the process will now rely on far more scrutiny of Telstra's actual costs, and on the historical patterns in Telstra's volumes and costs.

In that light, we consider that there is an even greater imperative for transparency of both data and calculations applied to that data:

- confidentiality is claimed by Telstra over RAF data that is critical to understanding how the ACCC has derived its cost and demand forecasts.
- the ACCC's draft report and accompanying calculations (e.g. cost allocations) do not clearly and transparently link up with the indicative prices, and therefore risk misunderstanding and error.
- In some areas, there is insufficient justification of choice of parameter values.

We urge the ACCC to be as transparent as possible in drafting its final report, and re-visit some of those areas where its assumptions and calculations have not been adequately justified. We further comment on particular matters in the relevant parts of our report.

## **1.2 The structure of this report**

In Section 2, we comment on the move towards and BBM and the ACCC's choice of an opening RAB value.

In Section 3, we analyse the ACCC's costs forecasts for Telstra.

In Section 4, we analyse the ACCC's demand forecasts for Telstra.

In Section 5, we review the depreciation methodologies and asset life assumptions used in the BBM.

In Section 6, we review and comment on the cost allocations used in the BBM.

In Section 7, we analyse the incentive properties of the BBM regime and price setting process.

In Section 8, we comment on the LSS price setting process and the LSS cost model.

In Section 9, we comment on some remaining issues including the averaging and rounding up of indicative prices.

## **2 Moving to a BBM and setting the opening RAB value**

### **2.1 The new pricing principles are conceptually appropriate**

In the draft report, the ACCC sets out its view that the LTIE will be achieved by pricing principles with the following desirable features:

- a fair rate of return on investment (cost recovery)
- incentives for efficiency and innovation
- transparency and regulatory certainty
- competitive pricing

We agree that these are desirable features, although we think it could equally be argued that no single pricing methodology would be superior in all of these features.

The ACCC then concludes that a pricing approach based on a building block method (with no asset revaluations) to determine relevant costs will promote the LTIE. For the reasons that the ACCC sets out (and that we also set out in our previous reports to the ACCC), we agree that there is merit to ‘locking-in’ a RAB for the next set of pricing determinations rather than continuing to revalue the asset base each time the ACCC determines prices.

We also support the ACCC’s decision to set access prices individually, rather than setting a broader cap on groups of services or of total network revenue. While this kind of regulation might be relevant for a structurally-separated supplier of fixed access services, while Telstra remains vertically-integrated a more intrusive approach to common cost allocation is required.

### **2.2 The methodology used to set the opening RAB is broadly appropriate**

In our February 2010 report, we noted that in locking in a RAB, the primary challenges for the ACCC are to:

- develop a suitable opening valuation for a ‘locked in’ RAB
- find a complementary method of accommodating new capital expenditure and depreciating existing sunk and new assets.

The ACCC proposes to use a depreciated actual cost (DAC) method to set the opening asset base, using the asset values from Telstra’s regulatory accounting

framework (RAF). This is based on its view that the access provider should be allowed to recover its actual investment costs and dissatisfaction with other methods such as DORC which (aside from allowing recovery of costs not actually incurred) is complex and subjective to implement.<sup>1</sup>

In contrast, a DAC approach is found to be more encouraging of future investment and more reliable, because a source of objective information already exists (the RAF).

We support the ACCC's views expressed in section 5.5 of the draft report.

We note that the ACCC has not attempted to estimate past compensation recovered by Telstra in relation to its CAN and Core networks. Our view is that this would be a conceptually more appealing approach for the reason that it would better reflect actual cost recovery. It is important to remember that the RAF applies straight-line depreciation, but no regulation was in place which restricted Telstra to *only* recover straight-line depreciation across the fixed line network. The reality is that Telstra has almost certainly recovered far more than straight line depreciation, and that the opening RAB value could be lower than proposed without adversely affecting Telstra's incentives to invest. Indeed, in 2003 the ACCC found that:

Apparent rates of return from the PSTN are well in excess of Telstra's weighted average cost of capital.<sup>2</sup>

These rates of return were calculated after (straight line) depreciation had been deducted from profits.

Nonetheless, we recognise that it may be difficult to find reliable data to estimate past compensation. Using the RAF data therefore seems a reasonable compromise, although this generous treatment should then be remembered when setting other parameters in the BBM.

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<sup>1</sup> ACCC draft report, p. 25.

<sup>2</sup> ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*; October 2003, p. 45. See also the ACCC's study in 2001 which found that Telstra's EBIT return was well above its cost of capital for the years 1998-2001, available at [www.accc.gov.au](http://www.accc.gov.au).

## 3 Cost forecasts

### 3.1 Forecasting principles

In a BBM, forecasts of costs and demand take on particular importance. That is because the values are generally set or accepted by the regulator *ex ante*, while the regulated firm's actual profitability depends on *ex post* outcomes. This fixing of parameters *ex ante* is thought to have desirable incentive properties, because the regulated firm is able to benefit from actions it takes to be more efficient (lower cost) or achieve more sales than forecast.

Nonetheless, these benefits come at a cost. The cost is that access seekers and consumers may pay more for services than they would strictly need to if regulation was more effective at constraining the regulated firm. A key way in which a regulated firm can take advantage of regulation is by putting forward forecasts that are too pessimistic (costs too high and demand too low) because this will enable higher profits to be made.

To limit this kind of regulatory gaming, it is important that forecasts meet certain standards. The ACCC outlines a set of principles for forecasting which it believes demand forecasts should meet (see Box 1). We support these criteria<sup>3</sup>, and would add that:

- these standards should also apply to cost forecasts
- the forecasting methodology and results should be transparent and well-documented.

Ideally, they should also allow for some flexibility, so that sensitivity analysis can be conducted (e.g. using different macro-economic forecasts).

We also support the ACCC's proposals that it produce the forecasts (at least initially), seek industry comment on the forecasts, and re-open the forecasts if out-turn demand is significantly different from forecast demand. In the initial regulatory period (if the ACCC retains its preference for four years), we would also support re-opening the cost forecasts as well if these are significantly different from out-turn costs.

#### Box 1: Forecasting assessment criteria

The ACCC will assess whether the access provider's forecast demand is reasonable in accordance with the following principles:

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<sup>3</sup> We proposed a similar set of standards in relation to Australia Post's forecasts for mail demand in our reports for the ACCC in 2009 and 2010. See <http://www.accc.gov.au/content/index.php/itemId/930276>

- the approach and methodology the access provider adopts must be appropriate
- the assumptions made by the access provider must be reasonable
- the data used must be current and accurate
- the key demand drivers must be taken into account (for example, these could include factors like population growth, technological advancement, household income)
- the methodology must be correctly applied
- the forecasts must be consistent with trends observed in actual historical RAF data, or it must be explained why a divergence from the trend is expected.

Source: ACCC draft report

## 3.2 Review of Capex forecasts

In this section of the report, we review the ACCC's Capex forecasts for Telstra.

The ACCC's basic forecasting assumption is that Capex over the regulatory period 2011-14 will be approximately the same as the five year average of past capital expenditure (in real terms) on assets used to provide the declared fixed line services.

The ACCC considers a number of data sources, and links its forecasts to values from Telstra annual reports, which are averaged and rounded.

An initial concern we have is that the ACCC's estimates of historic Capex may include abnormal Capex for which Telstra will already have received tied revenue; for example, installation charges or Government subsidies. These costs would form an inappropriate basis from which to forecast future costs and should be excluded, if possible.

### 3.2.1 The forecasts should be appropriately indexed

We understand that the ACCC indexes past capital expenditure to ensure that its forecasts sufficiently take into account changes in the prices of fixed line service inputs. The historical Capex data to 2009-10 values is indexed using a 50/50 blend of:

- the annual change in an ABS wage price index for the private communications sector
- the annual change in an ABS producer price index for electronic equipment and other machinery used in the manufacturing industry.

The latter index does not seem appropriate for telecommunications equipment. In particular, it does not seem credible to us that telecommunications equipment costs would have been rising over the historic period. The ABS also publishes an import price index for telecommunications capital equipment, which we consider

is likely to better represent telecommunications equipment prices given most of the electronic equipment is imported.<sup>4</sup> This index exhibits a downward trend in prices, as we would expect. The annual price changes for this index compared to the index used by the ACCC are shown in Table 1 below.

Table 1: Price changes for indexing prior year expenditure

Year	ABS electronic equip and mach price change (%)	ABS telecom equip imports price change (%)	ACCC calculated price change (with labour price change) (%)	Combined telecom imports and labour price change (%)
2005-06	7.8	-10.9	5.6	-3.8
2006-07	8.3	-9.4	6.3	-2.6
2007-08	0.5	-14.7	1.8	-5.8
2008-09	0.6	8.1	1.6	5.4

Source: Frontier calculations on ABS and ACCC data

Table 1 also shows the combined annual price changes for the ABS telecommunications equipment import price index and the labour price index as well as the combined changes for the ACCC's indexes. Use of our combined annual price changes serve to deflate capital cost in the first three years rather than to increase them as the ACCC's combined price changes do. This therefore produces a lower historic average, and therefore a lower forecast, for capital costs.

The results of this revised indexing is summarised in Table 2. It indicates that the ACCC has likely overstated prior capital expenditure in real terms by close to \$140m per annum.

<sup>4</sup> ABS, *International Trade Price Indexes*, Cat. No. 6457.0 June 2010, available at [www.abs.gov.au](http://www.abs.gov.au)

Table 2: Re-indexing capital expenditure forecasts

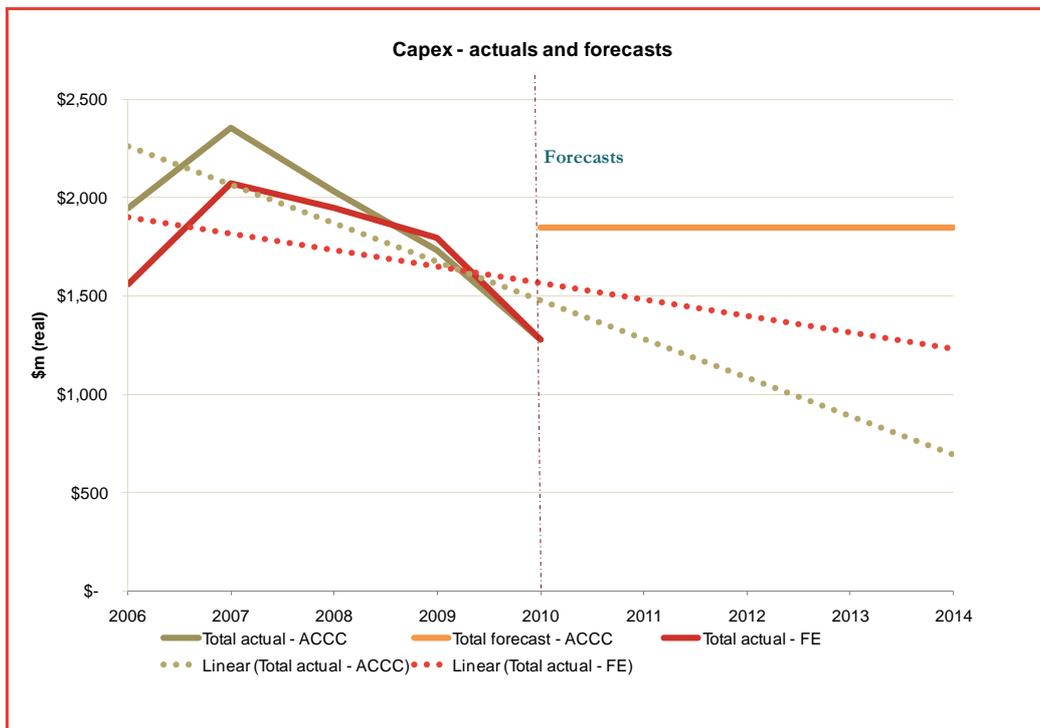
Year	ACCC Capex values (\$m)	Revised Capex values (\$m)
2005-06	1,948	1,561
2006-07	2,355	2,071
2007-08	2,030	1,949
2008-09	1,732	1,797
2009-10	1,279	1,279
<b>Average 05-06 to 09-10</b>	<b>1,869</b>	<b>1,731</b>

Source: Frontier calculations on ABS and ACCC data

### 3.2.2 The forecasts should account for historical trends

Our review of the ACCC's forecasts suggests that it has not appropriately accounted for historical trends in Capex. The ACCC notes that the data is volatile. Nonetheless, there is an obvious trend for Capex to be falling – regardless of whether our indexed numbers or the ACCC's indexed numbers are used. We demonstrate this in Figure 1 below.

Figure 1: Capex historic trends and forecasts



Source: Frontier analysis of ACCC data

It is apparent from Figure 1 that:

- regardless of which indexation method is used, Capex has historically been trending downwards. Both simple linear trendlines have a negative slope.
- if this trend were reflected in forecasts, the forecasts would need to be significantly reduced, from \$1.8bn to something less than \$1.5bn per year.

We also question whether the 2007FY Capex can be considered normal given Telstra's well-known investments in its new all-IP core network at that time. Removing or normalising that year's investment would lower average Capex substantially.

In Telstra's last annual report (2009/10), it concluded that across its overall business (i.e. broader than the PSTN) future Capex was more likely to be in line with the Capex experienced in the 2009/10 year:

Accrued Capex declined by 24.5% to \$3,471 million or 14% of sales revenue (p. 29).

Excluding any possible spectrum acquisition costs, we foresee Capex/sales around the 14% level for the medium term. (p. 51).

This suggests that the ACCC should place greater weight on its more recent (lower) estimates of Capex. At the least, Telstra should be required to justify why its expenditure should be any higher than that level.

### 3.2.3 The forecasts should be consistent with cost drivers

The ACCC also indicates that forecasts should be consistent with underlying drivers. However, it does not comment on the trends in particular cost drivers (for example, employee costs or equipment costs).

In this case, we consider that the ACCC has overlooked another significant factor that will drive reductions in Capex on the CAN – that Telstra will be expecting to decommission its copper network within 10 years (with the exception of the passive assets, which may be leased to NBN Co). In commenting on the NBN Co Heads of Agreement, Telstra's CFO indicated that:

...yes we have factored in some lower CAPEX on the CAN, but as you probably know, we're not spending a lot of money on the copper network now. Of course we're repairing or replacing and making sure we're providing service to our customers...<sup>5</sup>

## 3.3 Review of Opex forecasts

The forecasts for Opex are based on indexed historical expenditure and, for reasons outlined below, appear likely to overstate actual costs.

### 3.3.1 The forecasts should account for historical trends

The ACCC has not supplied the historical Opex levels from the RAF on which it has based its Opex forecasts for the CAN and the core network. Therefore it is not possible for us to review and determine the historical trend. This is not desirable and makes the ACCC's forecasts lack transparency. We urge the ACCC to release this data to scrutiny.

Further, the ACCC does not appear to have examined some important trends in the historic drivers of Opex costs. We note that, for example, Telstra has reduced its overall workforce by 12,192 (leaving aside acquisition and divestment activity) in the 5 financial years to 30 June 2010, including streamlining of its field workforce.<sup>6</sup> Labour costs are reported to have fallen by 6.2% over the past financial year.<sup>7</sup> This suggests that the trend in labour costs is likely to be down, and that the ACCC should rely more heavily on more recent years of Telstra's historical Opex to set its forecasts (i.e. the RAF does not reflect an efficient level of expenditure as has been assumed by the ACCC).<sup>8</sup>

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<sup>5</sup> <http://www.telstra.com.au/abouttelstra/download/document/tls731-nbn-transcript.pdf>

<sup>6</sup> Telstra Corporation Limited, *Full year results and operations review - June 2010*, p. 20.

<sup>7</sup> *ibid.*

<sup>8</sup> ACCC Draft report p. 81.

### 3.3.2 The forecasts should be appropriately indexed

As for Capex as described above, the ACCC indexes the historical Opex data to 2009-10 values by using a 50/50 blend of the change in an ABS wage price index for the private communications sector and an ABS producer price index for electronic equipment and other machinery used in the manufacturing industry.

If we substitute the ABS telecommunications equipment import price index for telecommunications equipment for the producer price index, the effect is to *deflate* annual Opex in simple average terms over the period 2005-06 to 2008-09 by 1.4% – rather than to *inflate* it by 7.8%, which occurs with the ACCC's index. We therefore expect that the indexing methodology applied by the ACCC to the historical Opex data overstates the true value of this expenditure, and this is reflected in higher-than-efficient forecasts.

### 3.3.3 The forecasts should be consistent with cost drivers

The ACCC forecasts that Opex will remain constant in real terms. This is contrary to a number of factors pointing to Opex falls. These are:

- the historical trend in the telecommunications equipment import price index showing a real fall in telecommunications equipment prices (and an overall fall in real prices based on a 50/50 blend with the labour cost index)
- Telstra's announced continued programme of workforce reductions and other efficiencies with respect to its field workforce<sup>9</sup>
- the recent large rise in the value of Australian dollar contributing to a fall in the cost of imported telecommunications equipment.

On the other hand, we would expect an aging network to require some additional maintenance expenditure over time.

The 10% allocation for corporate overheads assumed by the ACCC is not explained and should be justified.

### 3.3.4 Allocations of Opex to asset classes

The ACCC has allocated Opex to asset classes based on the gross historical costs of the asset as a proportion of the total gross historical costs of all assets. It considers this method superior to the alternative of allocating Opex on the basis of depreciated asset value as a share of the depreciated value of all assets.<sup>10</sup>

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<sup>9</sup> See for example Telstra Investor Day Transcript, 30 September 2010, pp. 48, 57 available on Telstra's website, [www.telstra.com](http://www.telstra.com).

<sup>10</sup> ACCC draft report p. 82.

We agree that the method used by the ACCC is preferable, as the alternative method will allocate more Opex to newer, less depreciated assets. That is contrary to how it would be expected Opex would be being spent. This seems to be borne out in the differences in Opex allocation for the core network between the two methods that can be seen in the Ovum BBM, which sees the latter method allocate substantially more Opex to inter-exchange cables, international network cables and transmission equipment at the expense of local switching equipment. The former three types of equipment are not considered to be highly Opex intensive. In relation to the CAN, the second method allocates substantially more Opex to ducts and pipes than cable compared to the first method, providing further reasons to doubt its accuracy given that cable is expected to be more Opex intensive than ducts and pipes.

## 4 Demand forecasts

In section 7.2 of the draft report, the ACCC concludes that Telstra and access seekers are best placed to estimate demand. Nonetheless, the ACCC has developed its own forecasts for the purposes of developing indicative prices. The ACCC indicates that it takes into account Analysys' forecasts from 2007 and further information on recent trends in demand.

Similar to the cost forecasts, we consider that the demand forecasts should be held to certain standards – they should identify how they are consistent with, or why they diverge from, historic trends; they should be transparent; and they should be consistent with underlying drivers of demand. We now examine the forecasts against these criteria.

### 4.1 The forecasts should account for historical trends and demand drivers

The ACCC indicates that it has had regard to historic trends in demand for fixed line services. It argues that these trends will continue with respect to PSTN OTA and LCS calls, but not continue for ULLS and WLR:

- ULLS demand is likely to taper from historic growth rates due to the uncertainty around future industry structure
- WLR usage has been declining but this is likely to slow as much WLR demand has been substituting towards ULLS
- PSTN OTA demand has been falling and will continue to fall at about the same rate as currently, due largely to substitution of mobile for fixed services
- LCS demand will decline in a similar fashion to PSTN OTA demand.

We have some concerns with these postulated trends.

#### 4.1.1 ULLS and WLR forecasts look too low compared to historic trends

The ACCC notes that it has taken into account actual rates of growth for ULLS to March 2010, but that it does not expect the substantial growth in ULLS to continue given the prevailing level of uncertainty. Total growth of 20% is then forecast to 2013/14.

Our view is that the ULLS demand forecasts are too low. Our main reason for holding this view is that 20% total growth would leave ULLS penetration at the end of the forecast period at an unusually low level compared to other countries.

As an example, we have compared the forecast rates of take-up with the *existing* rates of take-up in the UK and France, both of which have a broadly similar

regulatory structure to Australia's (in that both regulate access to both ULLS and LSS/WLR/LCS equivalents). A comparison is presented in Table 3.

Table 3: Comparing unbundled line penetration as a proportion of total fixed lines

	Total lines (SIOs), 2009-2010	Unbundled lines (ULL + LSS)
<b>UK</b>	31.2 million	7.1 million (22%)
<b>France</b>	29.6 million	7.7 million (27%)
<b>Australia</b>	10.0 million	1.56 million (16%)

Source: European Commission, Ovum ULLS benchmarking study, ACCC reports

We can therefore see that the ACCC's forecasts are not likely to achieve levels of penetration that have *already been reached* in the UK and France (of course, these levels could go even higher in these countries over the next four years, making the forecasts look even more conservative.)

A further point is that it is not likely to be necessary for existing entrants to enter new areas to increase ULLS penetration, particularly if there is spare capacity on existing DSLAMs.

We recognise that there may be some offsetting factors in Australia which might limit penetration (such as difficulties with accessing lines and backhaul in band 3 on commercial terms), but we still consider there is strong evidence that the ACCC's forecasts for ULLS are too low.

Forecasting WLR demand is challenging, due to both the lack of historic data and the close interaction between ULLS and WLR take-up. That is, there is a trend of WLR substitution towards ULLS as access seekers invest in voice-switching equipment, notwithstanding the lack of an effective WLR-ULLS migration process. There are a number of reasons, however, why the trend away from use of WLR may not continue and may, in fact, be reversed over the forecast period:

- there may be a slowing in new investment given current uncertainty – a factor the ACCC points to
- perhaps more importantly, the ACCC does not appear to have taken into account the change in relative prices between ULLS and WLR as a factor in WLR take up. Indeed, as we discuss below, the ACCC does not appear to have taken into account the fall in the absolute price of WLR which could lead to more WLR demand independently of ULLS take up.

### 4.1.2 There is limited transparency around PSTN OTA and LCS forecasts

It is difficult to comment on how the forecasts relate to historic trends in these call types because the ACCC has either not released the historic data on which it relies (PSTN OTA) or does not appear to have historic data (LCS). Nonetheless, the ACCC comments that its forecasts are based on an extension of the historic trend for these services: “recent trends in PSTN OTA demand will stabilise over the period”. LCS demand is assumed to follow the same trend – because it, like PSTN OTA, is affected by substitution to mobile calls.

Although we are unable to comment further on PSTN OTA demand, the forecasts for LCS will almost certainly deviate from PSTN OTA because of large relative price changes. We comment further on this below.

## 4.2 The forecasts should allow for demand elasticity effects

It does not appear that the ACCC has explicitly accounted for demand elasticity effects in any of its forecasts. This is an oversight that should be rectified.

The materiality of this omission will vary by service. More specifically, we would expect these effects to be material only where the anticipated prices changes are material. In that light, we have particular concerns that the ACCC’s forecast will understate demand for WLR and LCS services.

- LCS prices are to reduce from the current price of 17.36 cents per call down to 7 cents – a 60% reduction. We understand from discussions with access seekers that the actual current price paid for LCS is in reality much lower than this. Nonetheless, the move to 7 cents will still represent a significant price reduction.

Elasticity estimates for local calls are not readily available for Australia. Nonetheless, the ACCC notes that LCS calls are increasingly subject to substitution pressures from mobiles, and this appears to be supported by empirical evidence.<sup>11</sup> That is another way of saying that the demand elasticity

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<sup>11</sup> A survey of fixed-mobile substitution by Vogelsang finds that:

“Fixed-line elasticities for calls also have tended to stay in the inelastic range. Taylor (2002) reports about -0.50 for long distance and -0.25 to -0.40 for shorter distances. Ward and Woroch (2004) find them to be -0.3 for intraLATA and -0.7 for interLATA calls during the 1999-2001 period. However, for Austria during 2002-2007, Briglauer et al. (2009) recently estimated a long-run calling elasticity of -1.37 and a short-run elasticity of -0.74. This (together with the high positive cross elasticity mentioned above) suggests that the advanced FMS experienced by Austria may already have resulted in mobile calling being part of the fixed calling market.”

See [http://businessinnovation.berkeley.edu/Mobile\\_Impact/Vogelsang\\_Survey.pdf](http://businessinnovation.berkeley.edu/Mobile_Impact/Vogelsang_Survey.pdf), p.15.

for LCS calls is likely to be increasing over time. Even if the own-price elasticity was as low as (say)  $-0.2$  and the price reduction as low as  $-20\%$ , this would imply that call volumes should increase (against a baseline) by  $4\%$ . An elasticity of  $-0.5$  (which does not seem implausible given the available empirical evidence) the expected volume increase would be  $10\%$ .

- WLR prices are to reduce by between  $22\%$  (residential) and  $26\%$  (business). Of course, given the potential for substitution between WLR and ULLS it would be very difficult to estimate the volume effect of this price change. However, it seems implausible that substantially lower WLR prices would not result in an increase in WLR demand.

## 5 Depreciation and asset lives

### 5.1 Straight line depreciation is an appropriate methodology

There are two relevant elements to depreciation to consider:

- the depreciation of the existing RAB
- the depreciation of new capital expenditure

We support the ACCC's proposed approach of using straight-line depreciation. Although in principle we also support the ACCC's view that the straight line profile should be altered to smooth prices or to create a glide path, we are not convinced that there is a need for price smoothing in current circumstances. In particular, the ACCC's approach of averaging prices across time seems to have little to recommend it.

We understand that the purpose of price smoothing is to avoid relatively large changes in prices (potentially up or down) over the price-setting period. However, there are no large price changes proposed (when considered over a four-year period) and prices are explicitly set for the period, so there is no uncertainty. But by ignoring the trend for some service prices to increase (ULLS, WLR) and some to decrease (PSTN and LCS), the ACCC will face a bigger problem relating to price shocks at the start of the next regulatory period (i.e. 2014-2015) because prices will be further away from the BBM-calculated costs than they need to be.

The ACCC also proposes to use straight-line depreciation for new capital expenditure. We see no reason to deviate from this approach for new capital expenditure. To the extent that a different approach may be sought by Telstra, it should only be allowed with the agreement of the ACCC and (a majority of) access seekers.

### 5.2 Further justification for changes to asset lives is required

The remaining asset lives chosen are critical to the model prices. These in turn depend on the estimate of average asset lives and how depreciated the assets are considered to be.

Average asset lives are drawn primarily from the Analysys model. As we discussed in our February report to the ACCC, in the absence of better information from Telstra we think this is an appropriate assumption. Book lives, which are accounting records, are often shorter than economic lives, and it is our

understanding that Analysys has estimated economic lives using a range of data sources.

It is not clear on what grounds the ACCC seeks to lower asset lives for ducts and pipes to 30 years, other than it is 'conservative'. We think the ACCC needs to set out in more detail the counter evidence to the Analysys estimates and analyse its relevance before adopting the shorter period.

The ACCC recognises several weaknesses in its estimate of remaining asset lives. Foremost of these seems to be the reliance on the RAF as a source of information on depreciation, as the information in the RAF may not be especially accurate for some assets. Although the ACCC has this concern, it is not clear to us why there would be better available sources of data. It is not possible to use benchmarking studies on the remaining asset lives on other networks, because that information would not reflect Telstra's actual asset lives. Further, our understanding is that the RAF information is primarily drawn from Telstra's General Ledger accounts, which may indicate that no better primary sources of information are available.

The second weakness is said to be that lower prices for new assets might mean that remaining asset lives are understated (although it does say overstated which we assume is a mistake).<sup>12</sup> Given that new asset prices do not appear in the calculation of remaining asset lives (they are a function of gross and depreciated values, and average asset lives) the effect of this is not clear to us.

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<sup>12</sup> ACCC draft report, p. 80.

## 6 Cost allocations

### 6.1 The cost allocations are not sufficiently transparent and justified

To determine the cost allocation factors used in the Ovum BBM, the ACCC has made a number of adjustments to the cost allocation factors in the Analysys model that were previously used to determine indicative prices.

As a high level comment, we think that the ACCC's approach to the adjustment of these factors lacks rigour and is fraught with the risk of significant errors. It would be better to determine new cost allocation factors using actual and forecast line and traffic data along with the utilisation factors for the various types of PSTN equipment modelled.

#### 6.1.1 De-optimising adjustments appear arbitrary

The first adjustments by the ACCC were to 'de-optimise' some of the cost allocation factors used in the Analysys model. In respect of access services, this has had the effect of reducing the allocation of trench and cable costs to the ULLS relative to WLR as compared to what occurs with the Analysys model. This is because on a forward looking cost basis, the costs of the WLR relative to ULLS were lower compared to that determined on historic cost basis.

With respect to the core network, the ACCC was concerned that the legacy PSTN switching equipment was built to carry a higher level of voice traffic (and in particular even higher levels of PSTN OTA traffic which has declined more than Telstra's overall voice traffic). It therefore determined adjusted cost allocation factors for local switching by dividing forecast PSTN OTA traffic for each year into the 2002-03 levels of overall PSTN voice traffic. This has the effect of reducing these costs allocation factors (it seems primarily as an alternative to reducing the legacy costs). In this sense, we note it is more of an 'optimisation' exercise than a 'de-optimisation' exercise. Proportionate adjustments are also made to trunk and other switching equipment. All these adjustments seem somewhat arbitrary.

If the ACCC is concerned about the switching containing too much legacy costs, it would be better to make an adjustment to the costs themselves. It could then make an adjustment to the cost allocation factors to account solely for relative declines in traffic.

#### 6.1.2 Transmission equipment allocations contain errors

The second adjustment made by the ACCC was to reduce the Analysys cost allocation factors for transmission equipment used by PSTN OTA to reflect the

growth of data traffic that was under-forecast at the time the Analysys model was developed. This leads to a substantial fall in the allocation factor and the resulting share of the cost of transmission equipment that is allocated to the PSTN OTA service.

We have two specific concerns with this adjustment. First, having examined the derivation of the original PSTN OTA cost allocation factor for transmission equipment in the Analysys cost model, it appears that the model may allocate to PSTN OTA some of the cost of transmission that should be allocated to Telstra's retail services.<sup>13</sup> Second, we believe, the ACCC has made a mistake in making the adjustment to the Analysys model costs allocation factor. The ACCC has forecast a fall in the share of PSTN voice traffic in total traffic from {c-i-c} to {c-i-c} (a decline in share of {c-i-c}%). However, it then reduces the cost allocation factor from 23.1% to 13.4% which is only a decline of 42.1%. In applying a decline of 57.9% the correct cost allocation factor would be 9.7%. Further, in making this adjustment the ACCC seems to be assuming that all traffic uses the transmission equipment with equal intensity.

### 6.1.3 The data traffic assumptions are unrealistic

The third adjustment is to reduce the size of the cost allocation factors for transmission equipment for PSTN OTA over time to reflect projected growth in data traffic. The ACCC has done this by assuming that the percentage growth in data traffic is the same as the forecast percentage decline in PSTN OTA (and it seems overall PSTN voice traffic). As the ACCC admits, this is an assumption that is expected to understate the expected fall in PSTN OTA costs over time as data traffic is expected to grow much more than the decline in voice traffic based on historical trends ("data traffic has more than doubled each year for the past three years", p. 93).

We consider the nature of this last adjustment to be unnecessarily generous to Telstra, and that an adjustment should be made based on a forecast decline in PSTN voice traffic and increases in data traffic.

The stylised example in Table 4 below illustrates the potential impacts of the ACCC's approach. Assuming that there are two services voice and data currently utilising the transmission equipment such that voice accounts for 10 units and data 90 units giving cost allocation factors of 10% and 90% respectively. If it is assumed voice falls by 10% to 9 units and data rises by 10% to 99 units, the new costs allocation factors will be 8.3% and 91.7% respectively. If we assume data grows instead by a more realistic 50% to 135 units, the allocation factors will be 6.25% and 93.75% respectively. These levels of differences in the size of the

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<sup>13</sup> We communicated this in detail to the ACCC by e-mail on 14 October 2010.

allocation factors would translate to substantial differences in the PSTN OTA rate as modelled using the Ovum BBM.

Table 4: Stylised example of impact of differences in data traffic growth assumptions on cost allocation factors

Voice (units)	Data (units)	Voice allocation (%)	cost	Data cost allocation (%)
10	90	10		90
9	99	8.3		91.7
9	135	6.25		93.75

We also consider it is necessary for the ACCC to make an adjustment to the allocation factor for inter-exchange cables for increases in data traffic. This is because these cables are also shared with data services.

Finally, it is not clear to us why the PSTN OTA and LCS have some of the costs of international network cables allocated to them.

## 6.2 The demand forecasts should be linked to cost allocations

A weakness of the Ovum BBM is that the cost allocations are a user input, not an output of the model or linked to the Analysys model on which the allocations are based. The problem with this approach is that changes in the demand forecasts do not transparently feed through to changes in the cost allocations, and therefore it is not possible for a user without access to the cost factors to readily assess how different demand forecasts would affect costs and prices. It could also result in inconsistencies and errors in the modelling (if different demand forecasts were used to allocate costs and calculate prices).

The ACCC should correct this problem by transparently outlining its cost allocation factors (including its adjustments to the Analysys model), and then linking these to the demand forecasts in the Ovum model. This will ensure consistency of approach and increase the transparency of the ACCC's adjustments.

## 7 Incentives to promote efficiency

The ACCC addresses incentives mechanisms in sections 6.3 and 6.4 of the draft report. It proposes a number of mechanisms to ensure that only efficient Capex and Opex is recovered from access seekers.

### 7.1 The ACCC needs to make its proposals clearer

The ACCC's draft decision specifies actual prices that are to be set over the next four years. There is an implicit assumption that if actual costs deviate from costs forecasts in the BBM model, then Telstra will gain or lose depending on whether costs are higher than forecast, and these gains or losses all accrue to Telstra.<sup>14</sup> This is a relatively 'high powered' regulatory mechanism.

Given the power of the regulatory mechanism proposed, and the uncertainty over the accuracy of forecasts, it will be critical for the ACCC to clearly specify how it proposes to ensure only efficient expenditure is recovered. However, the ACCC's statements about efficiency mechanisms and incentive regulation are unclear in important respects.

- the ACCC says that prudency checks 'may' be applied, but does not specify in what circumstances they would be applied
- the ACCC says that a framework for assessing 'significant operating expenditure items' may be established, but then says 'this would mainly relate to capital expenditure'
- a carry-forward mechanism to share the benefits of efficiency gains is proposed, but not explained in detail.

We think that it is very important that the ACCC gives further consideration to exactly what these policies are and how it proposes to implement them. We are not clear how these mechanisms will interact with the ACCC's basic proposal of a four-year price cap mechanism with a specified price path, which does not seem to imply any role for prudency checks or frameworks.

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<sup>14</sup> This characterisation assumes Telstra can carry forward efficiency gains across regulatory periods. As we discuss below, we are not certain how the ACCC proposes the carry forward provisions should apply between regulatory periods.

## 7.2 Given uncertainty, the incentive mechanism may be too high powered

As we describe above, we consider that the proposed regulatory mechanism is relatively ‘high powered’ – in that Telstra gets to keep the majority of, or all, of the efficiency gains that it is able to make.

As we have noted above, we are not entirely clear how the carry-forward mechanisms work. Our interpretation is that the key incentive mechanisms embedded in the building block model are:

- Telstra is entitled to recover its forecasts of Opex, even if Opex is actually significantly lower or higher than the forecast
- The RAB will be rolled forward on the basis of *forecast* Capex and *forecast* depreciation, even if actual Capex (and actual depreciation) is higher or lower than the forecast.

These mechanisms provide strong incentives for Telstra to minimise Opex and Capex:

- all Opex underspend can be kept in the current regulatory period. In the next regulatory period, Opex forecasts are likely to be reduced, which provides a limit on how long the gains can be kept for
- Capex will be rolled forward on the basis that the forecast Capex was actually spent, meaning that the full amount of Capex reduction compared to forecast is captured. (There is some suggestion that Capex may be rolled forward into the next regulatory period on the basis of actual expenditure,<sup>15</sup> which would involve a sharing of gains with consumers, but this is not developed elsewhere in the draft report).

If our interpretation is correct, then the incentives will be so strong that the ACCC would need to have considerable confidence that its forecasts of Opex and Capex only account for efficient levels of expenditure. Our review of the ACCC’s draft report does not indicate that it has this confidence. It forecasts on the basis of historical Capex but later notes that:

...past investment trends may not be an accurate reflection of future capital investment requirements. The ACCC therefore considers it would be more appropriate for the access provider to provide capital expenditure forecasts...(p. 41)

A similar suggestion also applies to Opex (also p. 41).

Our review also indicates that the ACCC, in the face of uncertainty about costs, has been generous to Telstra for capital and operational expenditure (see section

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<sup>15</sup> ACCC draft report, p. 40.

3) and in rounding up prices beyond the levels that its costs estimates would indicate (see section 9.1).

We consider there are three alternatives that the ACCC should consider in getting the balance right between encouraging efficient expenditure and protecting the interests of end-users:

- shortening the initial regulatory period. While this might dull incentives for improved efficiency, it would mitigate the impact of mis-forecasting that allowed Telstra to extract rents from consumers, and deliver gains to access seekers and consumers earlier than otherwise. It may also be feasible to follow a shorter initial regulatory period (say two years) with longer periods (4-5 years) once there is more certainty about the accuracy of forecasting.
- rolling forward the RAB from one regulatory period to the next on the basis of *actual* costs and *actual* depreciation. As discussed in Biggar (2004)<sup>16</sup>, such a roll forward would preserve incentives to reduce Capex, as there would be a within-period gain from having actual depreciation lower than forecast depreciation, but would not allow these gains into the new regulatory period.<sup>17</sup>
- a mixed incentive regime, such as ‘sliding scale’ regulation. This might allow Telstra to keep 100% of efficiency gains up to a certain level, but beyond that level, require the gains to be explicitly shared with consumers (e.g. half the efficiency gains could be given to consumers in the succeeding regulatory period).

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<sup>16</sup> D. Biggar, Updating The Regulatory Asset Base: Revaluation, Roll Forward And Incentive Regulation, 1 April 2004, Prepared for the DRP Forum 2 April 2004, p. 3.

<sup>17</sup> As we note above this may be already contemplated by the ACCC.

## 8 LSS cost model and proposed indicative prices

The draft indicative price for the LSS is \$2.50 per service per month. This is the same price that the ACCC has been setting for this service since at least 1 June 2004<sup>18</sup>.

Section A9 of the draft report explains the basis upon which the ACCC has reached its view that this continues to be an appropriate price for the service. Here, the ACCC notes that:

- The price of the LSS is intended only to recover the incremental specific cost of providing the service (and therefore not to include a contribution towards recovery of the cost of the line over which the service is provided)
- The establishment of the LSS price has required the development of a separate pricing model containing capital and operating expenses associated with specific operational support systems required to provide the LSS, and other relevant services.

Importantly, the ACCC notes that the price of the LSS has been calculated outside of the BBM it has constructed to estimate the costs of the other fixed line services. It notes this is because:

... the price for the LSS is determined by reference to the costs associated with the specific operational support systems in place to facilitate LSS provision rather than the costs associated with access to the PSTN ...

...

... the ACCC's current view is that the LSS indicative price should be determined outside the BBM framework through the continuing use of the separate specific cost model and should remain at \$2.50 per month.

Close inspection of the model developed by the ACCC to estimate the specific costs of providing access to the LSS shows, however, that:

- The ACCC's model is in fact largely populated with outdated data not relevant to the period of the pricing principles, and does not estimate a number anywhere near \$2.50 per service per month
- The ACCC model does not follow the pricing principles set out in the ACCC's draft report because it is a TSLRIC model that involves the recovery of costs assumed to occur at the start of the modelling period that, in reality,

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<sup>18</sup> See ACCC, *Access Dispute Between Chime Communications Pty Ltd (Access Seeker) and Telstra Corporation Limited (Access Provider) – Line Sharing Service (LSS): Publication of Final Determination and associated Assessment of reasons under Section 152CRA of the Trade Practices Act 1974*.

are likely to have instead been incurred in the distant past and likely long-since already been recovered

- Contains errors in its approach to demand forecasting that has the effect of under-estimating demand for the LSS (and therefore over-estimating the quantum of LSS-specific – and indeed ULLS-specific – costs estimated by the model).

On the basis of these observations, the ACCC does not appear to have a reasonable basis upon which to set a price for the LSS of \$2.50 per service per month.

Instead, the evidence before the ACCC suggests that a reasonable price for the service should be somewhere well below \$1 per service month, and possibly below \$0.50 per service per month.

Our views in support of these conclusions are set out below.

## 8.1 The LSS indicative price is substantially above the ACCC's cost model estimate

The most glaring observation to be made about the ACCC's LSS specific cost model is that the price specified for the service in the draft report bears no resemblance to the cost estimate contained in the model.

Despite our concerns that the ACCC has over-estimated Capex and Opex levels (as set out in sections 8.2 and 8.3 below), and under-estimated demand for the service (as set out in section 8.4 below), the ACCC's model still derives unit cost estimates for LSS Capex and ULLS Opex<sup>19</sup> for 2009/10, 2010/11 and 2011/12. These numbers suggest upper-bound monthly LSS cost estimates equal to those set out in Table 5 below.

Table 5 LSS cost model estimates

	2009/10	2010/11	2011/12
<b>Cost model estimate</b>	{c-i-c}	{c-i-c}	{c-i-c}

Source: LSS cost model

These estimates are less than half the price specified for the LSS in the draft report. It makes no sense to us to construct a model to estimate the cost of

<sup>19</sup> ULLS Opex figures should be considered as an "upper-bound" for LSS Opex figures. This is because the model notes in cell A109 of the "Inputs" workbook that "LSS opex figures are not used in calculation on the "Final results" page; Opex allowance for each service is based on (higher) ULLS values".

providing the service, and then set a ‘cost-based’ price that is more than double the output that results from that model.

As discussed in more detail in section 8.5 below, we have seen no compelling evidence or explanation from the ACCC to suggest why such a substantial uplift above cost is warranted.

## 8.2 The LSS cost model is a TSLRIC model at odds with the ACCC’s new pricing principles

The ACCC’s draft report represents a watershed in its approach to pricing of fixed line services because it moves away from determining prices based on estimates of the forward-looking TSLRIC of providing these services. Importantly, it departs from its previous pricing principle which involved estimating the costs of providing a service by first assuming that the network used to provide the service was being rebuilt at the commencement of the regulatory period using the most efficient means available at that time. Instead, the ACCC argues in its report that it would be more appropriate to shift to a depreciated actual cost (DAC) pricing principle. For reasons set out in previous submissions we have made on this issue, we are in agreement with the ACCC’s change of approach on this matter.

Notwithstanding this, the ACCC does not appear to have carried forward this change in methodology to its estimate of the cost of providing the LSS. Instead, the LSS Specific Costs Model appears to proceed on the basis that all LSS specific costs would be “re-incurred” on 1 January 2009, and need to be recovered in subsequent periods.<sup>20</sup>

Close examination of the “TSLRIC values” worksheet in the LSS cost model appears to indicate that the ULLS and LSS Capex cost estimates are determined having regard to actual costs assumed to have been incurred by Telstra from 2000 to 2006. These costs have then been converted into 2009 equivalents using an escalation value set with reference to consumer price index (CPI) estimates. We note that this index does not include any adjustment for changes in price trends for telecommunications equipment as the ACCC has done for capital costs in the BBM (i.e. it appears simply to be an unblended CPI adjustment). Further, there is no evidence to suggest these adjusted actual cost figures have been depreciated in line with the ACCC’s DAC pricing principle.

We do not see any reason why it is appropriate to apply a DAC model for estimating the cost of all other fixed-line services, but continue to apply a

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<sup>20</sup> This would appear to be confirmed by the “TSLRIC values” worksheet; cells B9, B14 and B19 of the “Inputs” worksheet; and cell C5 of the “Final results” worksheet of the LSS cost model.

traditional TSLRIC model for the LSS. The arguments presented by the ACCC in support of a move to a DAC methodology should apply equally to all fixed-line services. This is especially the case when it appears likely that many of the capital costs assumed to be incurred in the LSS model have already been recovered in previous periods, as discussed in section 8.3 below.

### 8.3 The ACCC seems to allow recovery of capital costs that have already been recovered

The LSS specific cost model sets out Capex estimates for the ULLS, LSS and for Telstra's internal ADSL services. As indicated above, these appear to be assumed to be incurred on 1 January 2009, and represent costs that are to be recovered over future periods, including a 4-year period that would conclude on 31 December 2012.

It appears to us, however, that much (if not all) of the LSS and ULLS Capex costs refer to those that have actually been incurred in the past. We question whether the totality (if any) of these costs need to be recovered after 2009 given Telstra has been charging for the recovery of these costs through prices for the LSS and ULLS in previous years. That is, these costs should already have been recovered via past pricing for the LSS and ULLS. Indeed, as set out in section 8.4 below, it would appear the ACCC may have under-estimated demand in past cost model estimations such that Telstra has *over-recovered* these previously incurred costs.

While it is possible that additional Capex will need to be incurred by Telstra during the period covered by the indicative pricing principles, the LSS specific cost model does contain estimates of future Capex requirements. We have not reviewed the sources of these estimates as they are mostly contained in confidential submissions made by Telstra in previous arbitration processes.

Finally, the LSS specific cost model also estimates Capex costs for Telstra's internal ADSL services. However, the basis for estimating these costs seems particularly imprecise. The LSS cost model indicates these Capex numbers have been estimated by *simply doubling* Capex estimates for the ULLS, with no supporting reasoning provided for this decision.<sup>21</sup> The only basis we have found for such a crude cost estimate is references in the ACCC's Final Determination in relation to the LSS arbitration between Telstra and Chime made on 12 July 2007.<sup>22</sup> The Final Determination does not, however, set out any particular

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<sup>21</sup> See Cell B2 of the "Inputs" worksheet.

<sup>22</sup> See ACCC, *Access Dispute Between Chime Communications Pty Ltd (Access Seeker) and Telstra Corporation Limited (Access Provider) – Line Sharing Service (LSS): Publication of Final Determination and associated Assessment of reasons under Section 152CRA of the Trade Practices Act 1974*.

evidence in support of this conclusion. We believe the ACCC needs to improve the transparency of the basis for this estimate, and set out evidence it has in support of it being appropriate.

## 8.4 The ACCC's LSS demand forecasts are inconsistent with actual data available to it

The ACCC's forecast demand estimates for the LSS are set out in the inputs worksheet of the ACCC's LSS cost model,<sup>23</sup> and are reproduced in Table 6 below.

The ACCC's LSS model also contains notes setting out the source of the demand estimates contained in its model. These notes indicate that the ACCC:

- has relied on actual demand for the LSS at the mid-point of each financial year (i.e. 31 December) for the first two years of its demand series (i.e. 2007/08 and 2008/09). These actual demand estimates come from its "Snapshot of Telstra's customer access network", which is published quarterly on its website
- has forecast demand for subsequent periods (i.e. 2009/10; 2010/11 and 2011/12) by applying a forecast growth rate to actual LSS demand estimates for 31 December 2008. The assumed growth rate for each period is also set out in Table 6 below.

Table 6 Demand forecasts in the LSS cost model

	2007/08	2008/09	2009/10	2010/11	2011/12
<b>ACCC model</b>	373,288	498,988	{c-i-c}	{c-i-c}	{c-i-c}
<b>Forecast growth rate</b>			{c-i-c}	{c-i-c}	{c-i-c}

Source: LSS cost model

Frontier has two main concerns with the ACCC's approach to demand forecasting:

- First, the ACCC uses a forecast estimate for 2009/10, when it has actual data available to it to estimate demand for this period. That is, the ACCC has already published LSS demand figures for 31 December 2009 of 669,633 SIOs, which is greater than the demand "forecast" in its model for this historical figure. It makes no sense to us to use forecast figures for 2009/10

<sup>23</sup> They can be found at cells B38 to F38 of this worksheet,

when the ACCC has actual data available to it for this period. Such an approach is also inconsistent with the ACCC's own forecasting assessment criteria set out in Box 1 of this report.

- Second, the growth rates estimated for future periods are simply estimated by assuming a rate of growth of {c-i-c} from 2008/09 to 2009/10, and then halving this rate of growth in each of the two successive periods. Our concerns with the ACCC's simple approach to demand forecasting are set out elsewhere in this report. In the case of LSS, however, its assumed growth rates appear excessively conservative, and are giving rise to demand "forecasts" that are significantly less than actual demand levels the ACCC has published for some of these periods. For instance, not only is the demand forecast for 31 December 2009 below the actual level of demand published by the ACCC for this period, the ACCC's estimate for 31 December 2010 is roughly {c-i-c} actual demand levels it has published for 30 June 2010. For the ACCC's demand forecasts to be accurate, this would imply a rate of growth of {c-i-c} between June and December 2010 – a rate of growth which is inconsistent with the ACCC's forecast estimates for this period, and unlikely to reflect reality.

Further, Frontier notes that the ACCC appears to have made an error when applying demand forecasts in its model to estimate LSS Opex unit costs for past periods. That is, Frontier notes that the ACCC appears not to have applied its own actual demand levels to estimate LSS Opex unit costs for 2007/08 and 2008/09 in its model.<sup>24</sup> Had these actual demand figures been used, the demand forecasts in subsequent periods using the ACCC's conservative forecasting method would rise to reflect those set out in Table 7 below. Even these estimates would appear conservative as actual LSS demand figures for 30 June 2010 indicate that demand is growing faster than 17% per annum during the 2010 calendar year.<sup>25</sup>

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<sup>24</sup> In this regard, the demand forecasts set out in cells B105 and C105 in its cost model are substantially below the actual demand estimates it has in its model at cells B37 and C37.

<sup>25</sup> That is, the ACCC's published demand figures for LSS increased from 669,633 on 31 December 2009 to 734,155 on 30 June 2010 – an increase of 9.6% over six months (or 19.2% if extrapolated out over the whole year). This is significantly greater than the {c-i-c}% assumed in the LSS model.

Table 7 LSS demand forecasts

	2007/08	2008/09	2009/10	2010/11	2011/12
<b>Revised estimate</b>	373,288	498,988	669,633	784,134	851,174
<b>Forecast growth rate</b>			17%	8.5%	0%

We also note that if the actual demand levels in Table 7 were used in the LSS model for 2007/08 and 2008/09, LSS unit Opex cost estimates would fall to only {c-i-c} and {c-i-c} per service per month respectively for these periods – approximately half the estimates set out in the ACCC’s model.<sup>26</sup> That said, given Opex costs tend to be more variable in nature than Capex costs, this may overstate the extent of the reduction from an under-estimation of demand.

It is not clear to us why the ACCC has retained demand “forecasts” for 2007/08 and 2008/09 in the current version of its LSS specific costs model. They are either an error, or a carry-over from demand forecasts used in previous versions of this model. To the extent they represent the later, this suggests LSS access seekers may have been paying a price for the LSS in excess of a reasonable estimate of the cost of providing this service on account of forecast demand estimates that have substantially under-estimated actual demand for this service.

## 8.5 The ACCC has no evidentiary basis upon which to conclude \$2.50 per service per month is reasonable

The draft report indicates that:

... the LSS indicative price should be determined outside the BBM framework through the continuing use of the separate specific cost model

As indicated above, however, the cost model referred to by the ACCC in its draft report does not generate a cost estimate anywhere near \$2.50 per service per month. Instead, it generates a cost estimate less than {c-i-c} per service per month.

The ACCC has subsequently advised interested parties that:

The LSS Specific Costs Model was only one of the factors taken into account by the ACCC in determining the draft LSS price. The ACCC did not have

<sup>26</sup> See cells B107 and C107 of the model.

available information to allow it to update the inputs to the model and consequently had concerns about the accuracy of the estimated costs.

Taking into account these circumstances and noting the market conditions, and having regard to price stability and the reasonableness of the proposed charge, the ACCC proposes maintaining the existing indicative price of \$2.50.<sup>27</sup>

It appears, therefore, that the ACCC has no cost modelling basis upon which to form a view that \$2.50 per service per month is appropriate for the LSS. Instead, it merely suggests such a price is appropriate in order to achieve price stability, and because such a price would be reasonable.

We do not believe that arguments around price stability are a sufficient reason for retaining a price of \$2.50 per service per month in this instance. The ACCC has set the same price for the LSS since at least 1 June 2004. Given the indicative pricing principles are set to apply until 31 December 2014, this would represent a remarkable period of price stability whereby prices for the service would not have changed for over a decade. If price stability were the over-riding goal of the ACCC, there would never be any reason to review any access charge.

## 8.6 Conclusions

The ACCC simply has no specific evidence before it to justify a price for the LSS at \$2.50 per service per month. Indeed, the available evidence suggests that an upper bound price for the LSS should be less than \$1 per service per month.

In an ideal world, the ACCC would amend its model and populate it with appropriate inputs to calculate a reasonable estimate of the cost of the LSS. We expect, however, that this may take some time to perform properly, and that the ACCC is aiming to release final indicative prices by the end of this year.

Accordingly, we recommend that the ACCC use the available evidence contained in the LSS Specific Cost model to set a price for the LSS in the short-term of no more than \$1 per service per month. In the medium-to-long term, we believe the ACCC should develop a more appropriately structured and populated LSS Specific Cost model to estimate a reasonable price for the LSS. This model should:

- Ensure Capex is valued on a DAC basis, consistent with the ACCC's pricing principle for fixed-line services. This would make sure that Capex estimates do not "re-recover" costs incurred and recovered in past periods
- Re-estimate LSS Opex in line with the principles used to estimate Opex in previous iterations of its model

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<sup>27</sup> ACCC, *Questions and Answers: Fixed Line Service Pricing review Draft report – Questions and Answers*, at "5. Q: How did the ACCC determine the LSS monthly charge of \$2.50? What factors were taken into account", on p. 3.

- Update demand forecasts so that, at a minimum, they reflect the most up-to-date actual data the ACCC has before it.

Once these improvements have been made, we expect a reasonable price for the LSS would be well below \$1 per service per month, and could fall to something less than 50 cents per service per month.

The difference between a price of \$2.50 per service per month and \$1 per service per month is not trivial. Using the ACCC's published LSS demand (June 2010); assuming no further demand growth after that period; and using the ACCC's nominal vanilla WACC of 9.14%, this difference in price amounts to access seekers paying over **\$42 million** more in present value terms to Telstra for the LSS over the four year period of the indicative pricing principles. The extent of this over-payment increases to over **\$56 million** in present value terms if the price of the LSS were to fall to \$0.50 per service per month, as we suspect a properly constructed model would suggest is appropriate for the service. These are cost reductions that access seekers will be unable to pass-through to end-users. The extent of the loss of welfare for end-users will be even greater if these price reductions led Telstra to decrease its own retail prices for end-users in response to reduced retail prices from access seekers.

To simply retain prices that have been set for the past six years and not seek to use available cost model information that suggests this price is well in excess of cost would not be good regulatory practice, and not be in the LTIE.

## 9 Setting prices for specific services

### 9.1 There is no basis for the rounding upwards of indicative prices

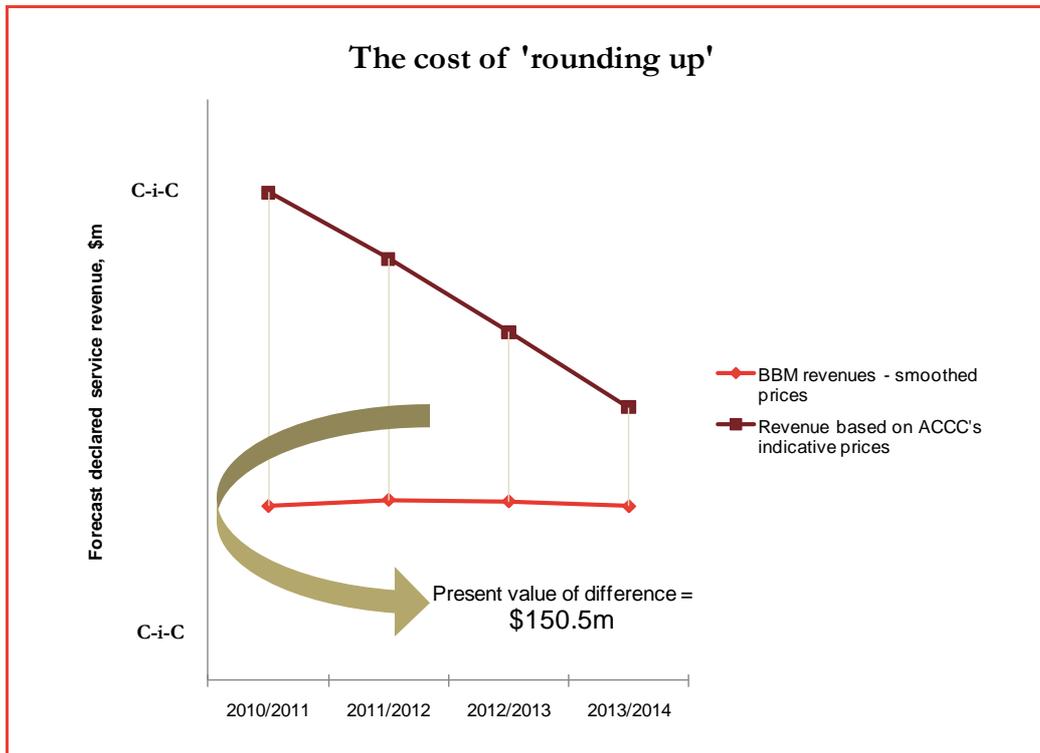
In examining the ACCC's indicative prices for the fixed services in its draft report and the prices determined by the Ovum BBM model, it is clear that in every case the ACCC has rounded prices up. In some cases this goes beyond rounding to the next highest whole number.

We do not believe this rounding can be justified on the basis that:

- the ACCC already seems to have been generous to Telstra with its calculation of the opening RAB and cost and demand forecasts, so it is a further over-compensation to increase prices by rounding
- if the ACCC has concerns about the veracity of the assumptions in the model, these should be addressed directly. Moreover, in rounding up, the ACCC implicitly assumes that errors will asymmetrically be to the detriment of Telstra.

We have modelled the impact of the ACCC's rounding, which we summarise in Figure 2 below.

Figure 2: Effect on rounding indicative prices on the revenue requirement



Source: Frontier analysis of Ovum BBM and ACCC indicative prices

We find that the revenue requirement is inflated by over \$190 million in nominal terms, which equates to just over \$150 million in present value terms over the four years when assessed at Telstra's WACC in the Ovum model. It could also be argued that the cost to consumers exceeds this amount, as, to the extent that access seekers pass through lower access prices, competition with Telstra will be intensified and Telstra would be forced to lower its prices as well.

Further, as discussed in section 5.1, we are not convinced that averaging of annual prices determined by the Ovum BBM to produce a constant value for each of the four years is necessary. While it has a negligible effect on the revenue requirement, smoothing provides no more certainty for Telstra or access seekers, and is more likely to lead to a jump in prices at the end of the four year regulatory period.

## 9.2 Geographic averaging of line rental and local calls is justified given retail price constraints

If there are substantial differences in the costs of supplying wholesale services between geographic areas, adopting geographically-averaged wholesale prices will risk distortions in investment and competition. Specifically, averaged prices will risk under-utilisation of access services and inefficient infrastructure by-pass in

lower cost areas, and risk over-utilisation and under-investment in by-pass infrastructure in higher cost areas.

However, the potential for distortion at the wholesale level also depends on the scope of distortions (price controls) on retail prices – specifically, controls on the prices of Telstra’s downstream retail services. Telstra is, in fact, prevented from geographically differentiating its retail telephony prices. These price controls require Telstra to offer the same prices for local calls and basic line rental between metropolitan and non-metropolitan areas of Australia.<sup>28</sup> Geographic de-averaging of wholesale prices for WLR and LCS would therefore distort competition in high cost areas because Telstra’s wholesale prices will be close to or above Telstra’s retail prices (which must be responsive to competition in lower cost area). The result would be to deter entry or aggressive price competition even where the access seeker is more efficient than Telstra at supplying retail services.

Our view is that the current retail price controls are a better reason for offering geographically averaged WLR and LCS prices than the ACCC provides – that the ACCC does not have access to geographically de-averaged cost data.<sup>29</sup>

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<sup>28</sup> See ACCC, 2009, *Telstra’s compliance with the price control arrangements 1 July 2008 to 30 June 2009*, p. 8.

<sup>29</sup> ACCC draft report p. 53.

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