RBS Group (Australia) Pty Limited
AFS Licence No. 247013
ABN 78 000 862 797
RBS Tower
88 Phillip Street
Sydney NSW 2000
GPO Box 4675 Sydney NSW 2001
Telephone: +61 2 8259 5000
Facsimile: +61 2 8259 5444
www.rbs.com.au

Submission on ACCC Review of the 1997 Telecommunications Access Pricing Principles for Fixed Line Services, Draft Report, September 2010

The Royal Bank of Scotland (RBS) makes this submission on behalf of a number of institutional investors. These investors hold substantial shares in Telstra and several may also have shareholdings in SingTel (owner of Optus), Telecom NZ (owner of AAPT) and several smaller telecommunications companies operating in Australia.

As well, RBS (then as ABN Amro) was a joint lead manager in the sale of the Government's stake in Telstra in 2006 (the T3 sale), as well as in the initial public offering in 1997 and the 1999 sell down.

In the lead up to the T3 sale there was considerable controversy over proposed access prices, notably the geographic de-averaging of ULL prices. We supported the ACCC's proposal then because we considered it had developed a well founded and consistent approach to access pricing. Despite the concerns of Telstra at the time we considered the process was sufficiently reliable for us to make good long term projections of the likely financial impact of access prices in a competitive market. We outlined to investors the access pricing approach and its potential impact on Telstra's operations in a major review of telecommunications regulation in July 2005 and used this as a basis on which to advise investors on access price developments in the lead up to the sale in October 2006.

Since the T3 sale and in particular over the past two years, our clients have seen a significant reduction in the value of their Telstra share holdings for a number of reasons. One of these in our view is that the access pricing regime has become less reliable since May 2009. (We draw a link between Telstra's share price, share price performance, its cost of capital and incentive to invest in infrastructure; we assume its an obvious link.)

For this reason we support the ACCC's proposal to adopt a 'building block' pricing approach with a regulated asset base. However, we have three fundamental concerns with proposals in the draft report:

- The use of historic cost is not relevant to investment decisions and is inconsistent with Subsection 152AB(2) of the TPA.

- The ACCC has no role in determining a preferred industry structure, or favoured access network investment
- Cost allocations that are inherently arbitrary should be transparent, clear and consistent in order to best meet the economic efficiency requirements of Subsection 152AB(2) of the TPA.

Use of historic cost is not relevant to investment decisions, and is inconsistent with Subsection 152AB(2) of the TPA

In our view the ACCC's proposal to adopt an initial RAB value of $7.5 billion for CAN assets and $5.8 billion for core assets based on depreciated actual cost (DAC) valuation methodology is inappropriate. Depreciated actual cost does not guide either efficient usage or efficient investment decisions, including decisions on ongoing investment to maintain the value in use of an asset. In our view such an approach would be inconsistent with Subsection 152AB(2) of the TPA.

The ACCC notes the circularity inherent in a NPV approach based on expected revenue but agrees that it would not necessarily prevent the use of this approach, because the current indicative prices have been subject to extensive regulatory scrutiny. We also point out that decisions by investors to invest in Telstra including in the T3 sale were informed by this approach to valuing the network, and many may have relied on it.

So where the ACCC says that the network costs using an NPV revenue-based RAB valuation "are not the actual costs incurred by the access provider", we disagree. The equity market makes this valuation on an ongoing basis. It is a real verifiable cost base, albeit combined with other drivers of Telstra's cashflow.

This doesn't necessarily lock in a value based on "the past application of a TSLRIC+ approach to setting prices" because the market valuation will adjust as circumstances affecting the cashflow derived from the network vary. We simply submit that the market derived valuation of the CAN is a more relevant approach than historic cost.

In the case of Telstra the most recent large market transaction guide to valuation (as opposed to valuation based on daily share transactions) of the access network was the valuation relied on by investors in the T3 sale of October 2006. We considered and advised investors at the time that the estimated valuation based in the long established access price methodology was in the order of A$25-30bn. We consider the equity market was aware of this and gave it significant consideration in the T3 sale process.

As a further indication that this is the relevant valuation basis, since that market transaction, the company has made access network capital maintenance decisions based on comparable valuation (that is to maintain that cashflow potential) and these incremental investment decisions have been supported by investors. We do not think Telstra's shareholders and the equity market would have supported CAN capital maintenance investment at the same level as Telstra has undertaken if the valuation was really only A$7.5bn.

We consider access prices that best meet the access price criteria of encouraging the economically efficient use of, and the economically efficient investment in, Telstra's

access network infrastructure may be best realised by taking the market valuation at the time of the T3 sale and adjusting for changes since then including depreciation and capital spend. We think this would provide a CAN valuation close to the amount we estimated and published in January 2010 of about A$23bn.

We also make the same point in relation to the ACCC proposal to take the access provider's past compensation into account when setting the opening RAB. Whether there has been cost over-recovery or cost under-recovery over the long term by taking into account is contentious and in any case not relevant to forward looking usage or investment decisions.

ACCC has no role in pre-determining a preferred industry structure or access network investment (at least not in its role in setting access prices)

The draft report says that "it has become clear that Telstra's copper CAN displays enduring bottleneck characteristics, rather than being a network likely to be bypassed through technological or market development. It is also unlikely that competitors will build alternate CAN infrastructure. The ACCC therefore considers that a replacement cost pricing approach, with its rationale of providing efficient 'build/buy' signals, is less applicable in the present environment."

We disagree with this assessment, particularly as it has been used to devalue the access network. Although the CAN may not be replaced in its entirety there are many, possibly over 100, access network companies (most, we understand, offering fixed wireless access) as well as companies offering circuit switched voice services that are likely to be affected by the proposed changes in access price. Nearly all of these are small, but so what? It doesn't matter that nearly all of them only operate at the margin of Telstra's network, that is where competition arises.

These companies should face a legitimate price signal based on market value to guide their investment decisions. We think this was an intention of Parliament in establishing 152AB(2) of the TPA, rather than necessarily leading to a replication of the CAN. At least the legislation does not make a distinction between such marginal or initial investment, and a replicated or alternative CAN infrastructure. As such, we think it is beyond the powers of the ACCC to impose such a distinction or a preferred form of access network investment or industry structure.

Cost allocations that are inherently arbitrary should be transparent, clear and consistent in order to best meet the economic efficiency requirements of Subsection 152AB(2) of the TPA

By their nature telecommunications network costs have a significant component of joint cost with respect to most relevant cost objects including access services. Allocation of joint cost is inherently arbitrary since, by definition, there is no separable cost causality at the level at which costs are joint.

The cost allocation principle most consistent with s142 may be based on demand elasticity, at least for armslength transactions. However, this may not be relevant for access prices given the nature of demand for bottleneck access services and the competition purpose of access pricing. As well, the regulator is not 'in the market' and

so is unable to see demand functions at a sufficient level to meet the efficiency requirment.

In the absence of direct cost causality or market demand signals, we suggest that the process that best meets the economic efficiency requirements of Subsection 152AB(2) is to use recognized and predictable cost allocation rules with a minimum of variation from period to period. An exception to this may be where there is a significant change in circumstances of the relevant access service that affects its ability to bear the same proportion of joint cost.

In the absence of direct cost causality or market demand signals, predictable cost allocation rules with a minimum of variation from period to period provides the most consistently reliable price signal to users and investors and so, we consider may best meet the economic efficiency requirements.

Instead the process used by the ACCC seems to lead to apparently arbitrary outcomes with the effect being significant changes to some prices and none to others. We note the ACCC has proposed moving from a retail minus approach for some services to cost based. Regardless, in the absence of underlying cost changes relevant to these services, price shocks, for instance as proposed by the ACCC in relation to WLR and LCS, seem not to be consistent with efficiency requirements. It is more difficult to make sensible investment decisions when prices may adjust to the extent proposed by the ACCC.

We thank you for considering our submission. We consider the ACCC has set a high standard for access price principles and prices in the past and this has been a positive factor in our view in encouraging investment in the sector. We hope this may continue to be the case with the proposed 'building block' pricing approach with an appropriately valued regulated asset base.

Ian Martin

Senior Equity Analyst,

Director, Telecommunications

The Royal Bank of Scotland