



Introduction

Telstra welcomes the opportunity to respond to the ACCC's fixed line services FAD 2018 preliminary consultation paper. Historically the setting of access prices for services on Telstra's legacy copper network has been an important feature of the regulatory framework for telecommunication services in Australia, with the objective of promoting the long term interests of end users (**LTIE**).

In preparing for this FAD inquiry we have made a preliminary update of the ACCC's fixed line services model (**FLSM**), and have applied the model consistent with the ACCC's application during the last FAD. Our update includes replacing forecast data with actual data where relevant, forecasting variables for the next FAD period (e.g. capex, opex and SIOs) and maintaining the application of the ACCC's "nbn scale adjustments". Consistent with the ACCC's application of the model in the last FAD, the model produces a once-off uniform price change to be applied to all regulated fixed line services. Our preliminary update of the model suggests a once-off uniform price increase of over **[c-i-c begins]** **[c-i-c ends]** in order to cover the building block revenue requirement.

However we are not pursuing such a price change. Today the relevance and importance of the legacy copper network for competition and telecommunications services in Australia is fast diminishing as the rollout of the National Broadband Network (**NBN**) nears completion — the vast majority of Australian consumers will soon have access to the NBN (**Figure 1**). In this environment Australian end users would be best served by an expedited and simple FAD process which provides price stability and certainty. This would ensure that end users that remain on the legacy network receive price protection.

Figure 1: Wholesales lines / SIOs on Telstra's legacy network

[c-i-c begins]



[c-i-c ends]

Importantly, price stability will also allow industry to focus on more important issues for the future of the communications industry, including NBN migration, mobile investment and 5G, for the benefit of Australian end users. Getting these areas 'right' for end users will produce more beneficial outcomes compared to a lengthy FAD process which sets prices for Telstra's legacy copper network services.



Telstra also notes that, from a timing perspective, the proximity of the NBN rollout completion and migration of customers from Telstra's legacy copper network to when the next FAD will expire brings into focus the costs of maintaining our legacy copper network. As illustrated in Figure 1, wholesale SIOs are expected to fall rapidly to very low levels over the course of the next FAD period. Many of the remaining customers will be in regional and rural areas served by NBN's fixed wireless and satellite technologies, i.e. in areas with a higher cost to serve. However, some satellite services in particular can be found in metropolitan areas and this poses the very real prospect that we may need to maintain a large number of exchanges in metropolitan areas for a relatively small proportion of customers. While Telstra receives USO funding, this funding (which the FLSM deducts from the revenue requirement) does not cover the costs of maintaining Telstra's legacy copper network for remaining customers.

The combined effect of being obliged to maintain copper to provide services to higher cost regional and rural areas and the dispersion of customers remaining on Telstra's copper network in metropolitan areas limits the cost savings Telstra can make — costs do not fall at the same rate as SIOs. This dynamic contributes to increases in unit costs and the estimated price increase of [c-i-c begins] [c-i-c ends] using the FLSM. Note that these higher unit costs arise from geographic factors and are unrelated to NBN migration and the "nbn scale adjustments", which are already accounted for in the FLSM.

Further, while we have made a preliminary update of the FLSM, given migration to the NBN is nearing completion Telstra considers that it will be difficult for the ACCC's FLSM to appropriately price remaining fixed line services — the building block model was not designed to apply to a network nearing its end of life. In particular, a building block approach would result in significant price increases for customers remaining on the copper network (even after allowing for the ACCC's "nbn scale adjustments").

Consistent with the view that the FLSM cannot appropriately price remaining services, it may be appropriate that the current fixed principles be allowed to expire. If this were to happen the ACCC should consider what guidance can be given around how it will approach pricing of fixed line services in any future FAD periods.

The remainder of this submission responds to the questions raised by the ACCC in its preliminary consultation paper.

Pricing structure

Question 1: The ACCC in its 2015 FAD inquiry for the seven declared fixed line services applied a nominal uniform price change to all declared services which maintained existing price relativities. For this FAD should the ACCC maintain existing price relativities for declared services or adopt a different price structure?

The ACCC should maintain existing price relativities for declared services, as was applied in the previous FAD. Given migration to the NBN will be completed during this next FAD period, there is no reason to introduce complexity in this FAD. In fact a move to more cost reflective pricing relativities may have the perverse effect of delaying migration to the NBN, would create price shocks and would mean higher prices for end users who remain on Telstra's legacy copper network (e.g. those outside the NBN fixed line footprint who are not required to migrate to the NBN). For these reasons Telstra believes it is in the best interests of end users if price relativities are maintained.

During the last FAD the ACCC applied a uniform price change to all declared services, maintaining price relativities between services. Key reasons for this decision were the desire for relative price stability and *"the unique circumstances of the compulsory migration to the NBN and the now limited*



period before the transition is completed'.¹ The ACCC also noted that while there would be efficiency losses associated with prices that did not reflect movements in cost relativities, these would be short-lived and be outweighed by the benefits of price stability.² These reasons are even more relevant today given the proximity of the NBN rollout completion.

Telstra also notes that moving to more cost reflective pricing could result in significant price shocks for most services (at least +/- 40% for all but one service).³ Price changes of such magnitude at the wholesale level (with implications for retail prices) could fundamentally change demand for services, resulting in a significant variance between the demand forecasts which underpin the price changes and the resulting actual demand for services. This variance would bring into question the basis for the price changes and may prevent Telstra from recovering its allowable revenue. Further, introducing such price shocks serves little purpose given the NBN rollout is scheduled for completion in 2020 and significant migration to the NBN will be completed during the term of the next FAD.

Finally, as previously noted, given the declining relevance of Telstra's copper network, there are other issues and areas where industry and other stakeholders would be better served directing their attention.

Factors affecting the cost of providing service

Question 2: There are a number of factors affecting the cost of providing fixed line and wholesale ADSL services. Do you have any views on the following potential drivers of cost and their impact on service prices since the last FAD?

- interest rates
- productivity levels
- fixed to mobile substitution as a source of declining demand for fixed line services
- input prices.

Updating the FLSM as part of the next FAD would be a complex and time consuming exercise. The model itself is large and requires a significant amount of data, and there would be varying views from stakeholders on the value of inputs to the model. A full and detailed update of the model could not be completed before the current FAD expires in June 2019.

Telstra's update of the model should therefore be considered preliminary and illustrative only. The update is largely 'formulaic' in nature, notwithstanding that we have updated old data and inputted forecasts for the next FAD period. The cost factors identified by the ACCC are reflected in the FLSM, either implicitly or explicitly. Telstra's preliminary update of the FLSM therefore captures the impact of these factors on service prices. Overall, our update of the FLSM suggests that prices would need to increase by over [c-i-c begins] [c-i-c ends] in order to cover the building block revenue requirement.

The following briefly outlines how each of these cost factors are reflected in the FLSM and the update applied:

- interest rates: for the purposes of the preliminary update, Telstra has used a WACC of 5.938%, based on the 2017-18 WACC applied to NBN in its LTRCM model. This is lower than the figure used in the last FAD (6.0012%) which has the effect of reducing Telstra's building block costs. We also note that this is less than nbn co's 2018-19 WACC of 6.216%. If the FLSM were updated as part of the FAD, we would need to consider all inputs to the WACC and CAPM calculations.

¹ ACCC 2015, *Public inquiry into final access determinations for fixed line services*, Final Decision, October, p. 12, available at <https://www.accc.gov.au/system/files/FSR%20FAD%20Final%20Decision%20Report%20-%20Public%20Version.pdf>.

² Ibid., p. 12.

³ Based on our update of the FLSM.



- productivity levels: Telstra has included cost reductions associated with the reduction in SIOs and, consistent with the previous FLSM, Telstra has also carried forward efficiency factors that were applied to the last FAD FLSM. These factors include assumed efficiency gains in network maintenance contracts (2% pa), engineering workforce (6% pa) and energy efficiency (1% pa).
- fixed to mobile substitution: the FLSM implicitly includes (through the SIO forecasts) a range of substitutions into cost and volume forecasts including, but not limited to, fixed to mobile. However, Telstra notes that the “nbn scale adjustment” in the FLSM effectively treats all reductions in SIOs as being the result of nbn migration which is not the case. We know an increasing proportion of customers are choosing to have no fixed line service and rely solely on their mobile service. So, this assumption that all SIO reductions are attributable to nbn migration is a shortcoming of the model, the effect of which is a lower price change calculation than would otherwise be the case. This shortcoming would need to be reconsidered if the FLSM were updated as part of the FAD process.
- input prices: interpreted broadly, input prices include all costs associated with capex and opex. Telstra has reflected reductions in input prices in the FLSM. Our preliminary update of the FLSM includes updating previously forecasted capex and opex with actual numbers, forecasting capex and opex for the next FAD period, as well as carrying forward efficiency factors as relevant. Updating input prices (i.e. capex and opex) is more complex in the current environment of NBN migration compared to a “steady state” scenario, for example because of uncertainty around timing of the NBN rollout and the rate of SIO migration. If the FLSM were to be updated as part of the FAD review, the ACCC, Telstra and other stakeholders would need to closely review all input prices that feed into the FLSM.

What is clear from the above is the complexity involved in updating the FLSM as part of the FAD process. While the price output of the FLSM could be used as a guide to the ACCC’s FAD decision, Telstra questions whether the benefits of a full FLSM update would outweigh the costs.

Question 3: Are there any other major factors that are likely to effect the cost of providing fixed line and wholesale ADSL services?

See response to question 2.

Future pricing

Question 4: In light of the influences affecting the cost of providing services since the determination of the current FAD, the ACCC is interested in views on whether there is justification for a continuation of fixed line and wholesale ADSL prices at their current levels.

Telstra believes there is some justification for maintenance of prices at their current levels. In our submission to the ACCC’s fixed line services declaration, Telstra gave support to an expedited FAD review process, including a simple approach to determining prices. We noted that it would be in the long term interests of end users and industry if the current price and non-price terms remain stable for the upcoming regulatory period.

Key reasons for this position were:

- *NBN roll out and migration is significantly progressed:* at the time of the last inquiry the rollout of the NBN was yet to hit significant scale. As at June 2015, there were only 500,000 SIOs and correspondingly there was a significant reliance on Telstra’s legacy services, with approximately [c-i-c begins] [c-i-c ends] wholesale SIOs (Figure 1). By the first year (FY20) of the next regulatory period Telstra forecasts approximately [c-i-c begins] [c-i-c ends] wholesale SIOs and only [c-i-c begins] [c-i-c ends] in FY24.
- *Avoids price shocks:* as noted, our preliminary update of the FLSM suggests that prices should increase by over [c-i-c begins] [c-i-c ends]. A simple price rollover which maintains prices



in nominal terms or alternatively allows for real price stability via a CPI adjustment is in the LTIE as it will prevent price shocks, particularly for those customers who are not required to migrate to the NBN.

- *Equivalence metrics demonstrate current pricing favours wholesale customers:* there is a significant and wide gap between Telstra’s External Wholesale Price (**EWP**, the price paid by access seekers) and Telstra’s Internal Wholesale Price (**IWP**, the price paid by Telstra’s retail business) (**Figure 2**) as determined by Telstra in accordance with its TEM reporting under Schedule 9 of the Structural Separation Undertaking. These equivalence metrics suggest that maintaining current pricing (and relativities) is likely to continue to favour wholesale customers relative to Telstra Retail.
- *Provides industry certainty:* the certainty provided by an expedited FAD process would allow Telstra and its wholesale customers to recontract on a timely basis, and to focus on more important issues such as NBN migration, and competition and innovation, for the benefit of end users.

It is for these reasons that Telstra supports a simple pricing approach which provides price stability. A nominal rollover of prices or a marginal price increase (e.g. reflecting movements in CPI) would fulfil our objective of price stability. Giving some support for a CPI adjustment, we note that costs of maintaining the network are not falling at the same rate as customers are migrating to the NBN (**Figure 3**), and the majority of remaining areas where customers are not required to migrate to the NBN are in higher cost regional and rural areas.

Further, our preliminary update of the FLSM suggests that prices would need to increase by over **[c-i-c begins]** **[c-i-c ends]** in order to cover the building block revenue requirement. This increase includes the ACCC’s “nbn scale adjustments”, and is a reflection of the higher costs of serving the remaining customers on Telstra’s legacy copper network. However Telstra is not seeking a price increase which allows for cost recovery under the FLSM. A CPI adjustment would not provide for cost recovery.

Figure 2: Telstra’s TEM reporting – internal and external wholesale prices

[c-i-c begins]



[c-i-c ends]



Figure 3: Telstra costs (FLSM revenue requirement) and SIOs

[c-i-c begins]



[c-i-c ends]

It is also the case that Telstra has continued to invest in our legacy copper network. Over the course of the current FAD period, Telstra's expenditure on the network has been consistently higher than the allowance set by the ACCC (**Figure 4**). For the four years to FY19, Telstra's actual network cost (allocated to regulated fixed line services) has exceeded the FAD allowance by over \$400M.

Figure 4: Telstra's current FAD allowed revenue requirement and actual expenditure⁴

[c-i-c begins]



[c-i-c ends]

⁴ For years 2015/16 to 2017/18, figures for Telstra's expenditure are actuals. For 2018/19, the figure is a forecast.



Consistent with this investment we have seen improvements in service quality for end users. This is illustrated by the fact that total ADSL network traffic (as indicated by network busy hour throughput) has doubled since FY14, and increased network capacity has supported increased customer demand which has seen an almost 3-fold increase in data consumption per customer since FY14 (**Figure 5**). The flattening in overall (and hence peak) network traffic in recent years reflects increased migration to the NBN.

Figure 5: Total ADSL network traffic (busy hour throughput) and data consumption per SIO (FY14 to FY18)

[c-i-c begins]



[c-i-c ends]

Pricing duration

Question 5: Is a single set of prices in the FAD for the entire five year declaration period for fixed line services appropriate? We note that by the end of the NBN migration period only the copper network in the NBN fixed wireless and satellite footprints in generally remote areas will remain in operation.

- a. **Would FAD prices be better determined by reference to pre and post NBN migration completion periods?**
- b. **Would a single period FAD be appropriate noting that a variation could be requested at a later date as the operational circumstances of the copper network in the post NBN migration period become clearer?**

For the following reasons Telstra supports prices applying to a single period FAD, with that period aligning to the 5 year declaration period recently determined by the ACCC.

- *Reduced complexity:* determining prices pre and post NBN migration would add complexity (and time) to the review process. For example, if the FLSM were updated as part of the review, this would be a significant undertaking by the ACCC and Telstra, with other stakeholders likely to also have views on the FLSM update. It is likely that a new pricing approach for the post NBN migration period would also need to be developed.
- *Promotes fit for purpose regulation:* consistent with a single period FAD reducing complexity, it would also promote regulation that is fit for purpose. The complexity of separate pricing pre and post NBN migration would add significantly to the costs of the regulatory process (due to, for



example, the need to update the FLSM and develop new pricing models). While it could be argued that prices may be closer to their efficient levels if pre and post NBN migration prices were set, the benefits of this are limited given the low SIOs remaining on the copper network. It is difficult to see the benefits of separate pricing outweighing the costs of their determination.

- *Avoids risk of material price increases:* post NBN migration there is a risk of material price increases in higher cost areas which continue to be served by Telstra's legacy copper network. While there may be some justification for the price increase, it would not be in the long term interests of end users who may be maintaining their copper services because of a lack of alternative services of a suitable quality.
- *Provides long term stability and certainty:* at a time of significant migration to the NBN and reduced relevance of Telstra's legacy copper services, a single set of prices for the next FAD period would provide stability and certainty for all industry participants. This stability and certainty would allow industry to focus on more important issues.

Also, Telstra notes that the FLSM has not been designed to calculate all fixed services prices for NBN's fixed wireless and satellite areas. Apart from ULL bands 1-3 and 4 and Wholesale ADSL zones 1 and 2/3, the FLSM is designed to provide national pricing for services. Uniform price changes rather than cost reflective price changes mean band/zone cost differences are not reflected through to wholesale prices. If the ACCC were to go to the effort of setting prices pre and post NBN migration completion, the assumption is that this would be a detailed exercise and would require a new price model that can price differentiate based on the NBN fixed wireless and satellite footprints, including customers in metropolitan areas being served by these technologies. It is unlikely that the benefits of such an approach would outweigh the costs. A simple pricing approach which provides price stability will provide pricing protection for access seekers (and ultimately end users), and is favoured by Telstra.

Fixed principles

Question 6: The FAD fixed principles in the current FAD are due to expire in 2021. Do you have any comments on the role of the fixed principles in the next FAD decision and their expiry or renewal?

Role of the fixed principles in the next FAD decision

The role of the fixed principles was considered by the Federal Court in the judicial review proceedings relating to the 2015 FADs, and by all stakeholders involved in those proceedings. The Federal Court found that the fixed principles are "*flexible and not immutable*".⁵ However it was noted that the ACCC had at least given consideration to the fixed principles when making the 2015 FADs, and the Court found no inconsistency between the requirements of the fixed principles and the determinations made by the ACCC.⁶ Thus, the fixed principles played a role in guiding those determinations and providing a degree of certainty around the ACCC's approach to certain aspects – but not all – of its pricing methodology.

Consistent with this, Telstra considers that the ACCC could have regard to the outcome of the building block methodology (as reflected in the fixed principles) in making the next FAD, but its determinations need not be tethered to the outcome of this methodology. The ACCC may be flexible in how it takes into account the outcome of the building block methodology (i.e. the revenue requirement and prices calculated by the FLSM), and may also take into account other matters when making its determinations. In particular, the ACCC may consider that the LTIE is best served by price stability, even if maintaining current prices would not deliver the revenue requirement calculated by the FLSM.

⁵ *Telstra Corporation Limited v Australian Competition and Consumer Commission* [2017] FCA 316, [180]-[181].

⁶ *Telstra Corporation Limited v Australian Competition and Consumer Commission* [2017] FCA 316, [172]-[173].



Expiry / renewal of the fixed principles

The fixed principle provisions were developed to provide certainty and transparency around the ACCC's approach to key aspects of the FADs, particularly its pricing approach. However Telstra envisages that, as we approach the end of the NBN transition period, a strict building block approach to pricing may not be appropriate, and that a different pricing approach may be required to accommodate a smooth transition.

The ACCC has previously noted that the circumstances of the NBN rollout and its impact on Telstra's fixed line asset are unique.⁷ However the existing fixed principles are not tailored to account for these unique circumstances. Rather, the existing fixed principles simply specify a standard building block methodology. The existing fixed principles and the FLSM were not designed with 'end of network life' and customer migration / transition issues as a central consideration, and so they do not offer clear guidance for how the ACCC should approach those issues. Also, the fixed principles and building block regulatory approach, as a form of incentive regulation, are less relevant for an 'end of network life' scenario as the inherent incentive mechanisms are of diminishing importance, consistent with the rapidly falling SIOs and revenues. And finally, the FLSM becomes increasingly difficult to apply as SIOs fall to low numbers — small variances in forecast SIOs (e.g. because of uncertainty around timing of the NBN rollout and rate of SIO migration) can lead to large variations in FLSM price outcomes.

Telstra therefore considers that the current fixed principles should be allowed to expire. The methodology specified in these fixed principle provisions is no longer appropriate or fit for purpose.

If the current fixed principles are to expire, and if the FLSM is to no longer be used, the ACCC should consider what guidance can be given around how it will approach pricing of fixed line services in any future FAD periods. In particular, the ACCC should consider how it will approach pricing for any fixed line services which continue to be declared in circumstances where the vast majority of customers have migrated to the NBN, but Telstra is required to maintain its network to support a relatively small number of services outside the NBN fixed line footprint (i.e. services which Telstra must maintain under its copper continuity obligations). This guidance does not need to be provided as part of this FAD review process, but should be given separate consideration prior to the expiry of the fixed principles in 2021.

Other

Question 7: Are there any additional issues or views you would like to share with respect to price and non-price terms for access to the declared services at this stage?

No further comment.

⁷ ACCC, *Public inquiry into final access determinations for fixed line services*, October 2015, p x.